ASSOCIATION OF BUSINESS TRIAL LAWYERS

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ORANGE COUNTY

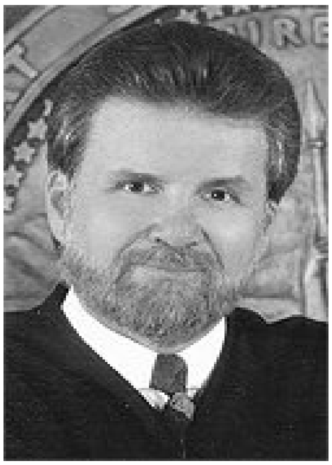
REPORT

Volume VIV No. 3

Fall 2007

Q&A with the Hon. William W. Bedsworth

By Linda A. Sampson



[Our judicial interview this issue is with noted legal humor columnist and Appellate Justice, William W. Bedsworth.]

Q: *Why did you originally decide to leave the practice of law to become first a Superior Court Judge and then an appellate justice? Do you have any regrets?*

A: Actually, I first decided to try for a judgeship in the early eighties. But my decision was to try for a *municipal court* judgeship. I was rejected for that position because the Brown Administration considered me way too conservative. Then I was rejected for it by the Deukmejian Administration which considered me way too liberal. I finally decided Eisenhower was right: "People who walk down the middle of the road get hit by trucks."

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Shareholder & LLC Member Suits: Direct or Derivative

By Alan Wechsler

Limited liability companies are increasingly being used as a form of business organization.[1] As a result, there has been a corresponding increase in the number of disputes between members of LLCs. One of the first issues that should be considered by counsel representing an LLC member who seeks to sue other members of the LLC, or by defense counsel representing an LLC or a member of an LLC in a suit by a member, is whether the plaintiff has standing to bring a direct action, or instead is required to comply with the rules that apply to corporate shareholders with respect to derivative lawsuits.

In the little known case of *PacLink Communications International, Inc. v. Superior Court*, 90 Cal.App.4th 958, 965 (2001), the Second District confirmed that the principles of derivative lawsuits applicable to corporations likewise apply to an LLC. LLC members and corporate shareholders, therefore, can bring two types of actions: a *derivative* action on behalf of the entity for injury to the entity for which the company has failed or refused to sue, or a *direct* action (sometimes referred to as an "individual action") brought by the member/shareholder individually for injury to his or her inter-

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1. A limited liability company, or "LLC," is a hybrid business entity formed under the Corporations Code and consisting of at least two "members" who own membership interests. The company has a legal existence separate from its members. The LLC form of organization provides members with limited liability to the same extent enjoyed by corporate shareholders, but permits the members to actively participate in the management and control of the company.

The President's Message

By James G. Bohm

As the end of the year approaches, I wanted to talk about the benefits of membership in the ABTL and to encourage everyone to renew his or her membership early. I also want to encourage firms to sign up their entire litigation departments to take advantage of discounted rates. I believe our mission statement provides the most important and valuable reasons for membership. It provides: "The mission of the Orange County Chapter of the Association of Business Trial Lawyers is to promote competence, ethics, professionalism, and civility in the legal profession and to encourage and facilitate communication between members of the Orange County bar and the County's federal and state judges on matters affecting business litigation and the civil justice system."

Through the various dinner meetings and annual seminars, the organization does an exemplary job of fulfilling its mission statement—promoting the highest degree of competence and professionalism while facilitating the interaction of the bench and bar. We have been fortunate to have the most highly regarded lawyers and judges in the state on our various panels presenting cutting edge programs—programs that give actual valuable and useable information. For example, we had a program that dealt with opening statements and presenting the issues from the perspective of the opposing party—advocating that the case should be presented as the opposing party having choices and making the wrong ones. We have had Justices from our Court of Appeal talk about what they are looking for in deciding appeals and how to present the issues in the briefs. These programs have given valuable practical advice. We are one of the few organizations that actually focuses on business litigation. One of the highlights at this year's annual seminar was Justice Sandra Day O'Connor giving the keynote address. This was historic because, as a retired justice, she had more flexibility in what she can say than a sitting justice does. Her comments focused on the importance of oral advocacy, a message that was brilliantly delivered and enthusiastically received by the judges and attorneys in attendance. Virtually every year we have either a state or federal Supreme Court justice at our annual conference.

While the quality of the programs, from both the con-

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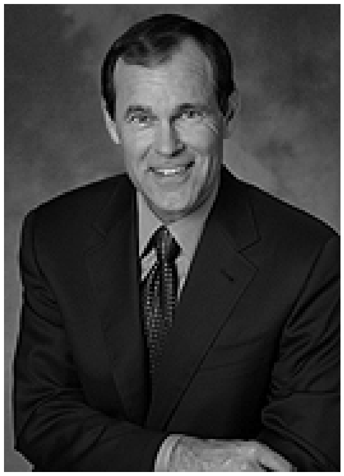
We're Not In Omaha Anymore…..
By Michael G. Yoder



It was 1980. I was a second-year litigation associate working in the Los Angeles office of Gibson, Dunn & Crutcher, and I had decided to transfer to the firm's Orange County office. When I announced my decision to one of the litigation partners for whom I had toiled over the past two years, his reaction was blunt and to the point: "Yoder, if you want to play in the major leagues, you don't go to Omaha."

Young enough to think I knew better (or perhaps foolish enough not to care), I moved to Orange County anyway. What I found when I arrived was, admittedly, a far cry from Los Angeles. In 1980, Orange County was known for its beaches, Disneyland, John Wayne, conservative politics, and not much else. Less than two million people called Orange County home, only a handful of publicly held companies were based here, and real estate development dominated an entrepreneurial business community.

The Orange County legal community reflected the entrepreneurial nature and spirit of the business community. Most of the county's lawyers worked in small firms or were solo practitioners. Knobbe, Martens, Olson & Bear had only seven lawyers. Only Rutan & Tucker, with a little over 60 attorneys, could be said to have a sizeable presence. Of the Los Angeles-based firms, only a few, including Gibson, Dunn, Latham & Watkins, Paul, Hastings, Janofsky & Walker, Wyman, Bautzer, Kucel & Silbert, Sheppard, Mullin, Richter & Hampton, and Irell & Manella had opened Orange County offices, but their offices were small: Gibson had the biggest office, with about 20 lawyers, Latham and Wyman, Bautzer each had about 15, Paul, Hastings had 12, Sheppard, Mullin eight, and Irell three attorneys. Morrison & Foerster did not open its Orange County office until 1988, and Jones, Day, Reavis & Pogue not until 1990.

Although a few of Orange County's leading trial lawyers, including Vern Hunt, Wylie Aitken, Mark Robinson and Tom Malcolm, had already made a name for themselves by 1980, Orange County's bar did not have near

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Top Quality Events: One of the Hallmarks of the ABTL
By Jeffrey W. Shields

As I reflect on the 10th Anniversary celebration of our Orange County Chapter of the Association of Business Trial Lawyers, I believe that one of its most impressive achievements has been the outstanding quality of its educational events. Indeed, the ongoing expectation that attendance at every ABTL program will prove to be of great worth to the business litigator -- whether the seasoned veteran or the less experienced associate -- has truly become a hallmark of ABTL.

At the time we founded the Orange County ABTL Chapter, we were well aware that the Los Angeles, Northern California and San Diego ABTL Chapters had already been putting on stellar programs for years, and there was certainly a strong desire among all of our founding members to promptly put Orange County on the statewide ABTL map. Visionaries like Don Morrow and Tom Malcolm insisted that we had to hit the ground running -- both with a big ticket speaker for our initial program, and with a well planned roster of top notch programs to follow.

We were very fortunate to secure the cooperation of Vincent Bugliosi as the featured speaker for our kick off program on June 4, 1997. Although he was then very busy on the post-O.J. speaking circuit, and initially reluctant to commit, I remember speaking with him about ABTL and the importance of forming our Orange County Chapter. Not only did he agree to our request, but he dramatically slashed his honorarium to help our fledgling organization (which didn't yet have any members and was essentially broke).

Over 200 people attended that first dinner program, including 30 judicial officers. Each of them also received a save-the-date flyer that night that listed each of the speakers for all of the upcoming dinner programs in 1997 and 1998. That list read like a "Who's Who" of the California legal world, and included legendary practitioners such as: Max Blecher, Jim Brosnahan, Joe Cotchett, Larry Feldman, Tom Girardi, Herb

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The Unforeseen Cost of Using Contract Workers
By John A. Vogt

Using contingent workers, or what are more commonly known as independent contractors, carries huge and, often times, unforeseen risks. Notwithstanding those risks, and the ever increasing numbers of lawsuits and administrative investigations regarding worker status, statistics show that employers continue to use temporary workers to supplement their regular workforce. Because many employers rely upon nonpermanent or contingent workers, employers must remain vigilant to this area of the law.

Laws governing employment taxes, employee benefits, workers' compensation, and anti-discrimination all involve issues of worker status. If a worker is found by a court or administrative agency to be an "employee" rather than a contractor, the employer could face steep fines, penalties and damages. Issues presently being litigated in this area include, among other things: (i) under what circumstances will temporary workers become full-time employees (and, thus, entitled to the wages and benefits of full-time employees); (ii) at what point in time do temporary workers become full-time employees; (iii) does the analysis change if the temporary workers are employed by an agency, which assigned them to the employer with whom they work every day; and (iv) the extent to which notions of common law principles can (or should) be used to alter employment arrangements defined by contract or statute (particularly with regard to public agencies).

The question of worker status — i.e., whether someone in the eyes of the law is an employee or an independent contractor — could arise in several ways. The most common example is when a worker files a claim for unemployment or state disability insurance, and an agency finds that the worker was an employee, rather than an independent contractor (notwithstanding the fact that the business believed that the worker was an independent contractor). In California, the Unemployment Insurance Code (CUIC) authorizes the California Employment Development Department (EDD) to conduct payroll tax audits of businesses operating in California. Those audits typi-

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A WORD FROM OUR SPONSOR: Valuation of Closely Held Businesses - New Standards
By Jaime C. Holmes

The American Institute of Certified Public Accountants (AICPA) has issued new regulations for the valuation of businesses, business ownership interest, securities or intangible assets, when such services are performed by Certified Public Accountants who are members of the AICPA.

The AICPA is a national organization of CPA's and issued Statement on Standards for Valuation Services, No. 1, which becomes effective January 2008. The issuance of this statement creates a new set of standards for AICPA members who perform business appraisal services.

The new standards were adopted by the AICPA to "improve the consistency and quality of practice among AICPA members performing business valuations." These standards will apply for business valuations for the following purposes:

<u>When is SSVS Applicable?</u> [1]

Transactions (or potential transactions), such as acquisitions, mergers, leveraged buyouts, initial public offerings, employee stock ownership plans and other share based plans, partner and shareholder buy-ins or buyouts, and stock redemptions.

Litigation (or pending litigation) relating to matters such as martial dissolutions, bankruptcy, contractual disputes, owners disputes, dissenting shareholder and minority ownership oppression cases, and employment and intellectual property disputes.

Compliance-oriented engagements, including (a) financial reporting and (b) tax matters such as corporate reorganizations: S corporations conversions; income estate, and gift tax compliance; purchase price allocations; and charitable contributions.

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1. SSVS No. 1 Forward

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est as a member/shareholder or to enforce a right that he or she possesses as an individual. These two types of actions ordinarily are mutually exclusive, *i.e.*, the right of action and recovery either belongs to the members/shareholders (a direct action) or to the LLC/corporation (a derivative action). *Schuster v. Gardner*, 127 Cal.App.4th 305, 311-12 (2005) (citations omitted). However, a member/shareholder may maintain both a direct action and a derivative action if he or she has suffered injury both as an owner of the company and in an individual capacity. *Denevi v. LGCC*, 121 Cal.App.4th 1211, 1221 (2004).

The failure of a plaintiff to sue derivatively where required can be attacked by demurrer, motion for judgment on the pleadings, or summary judgment on the grounds that the plaintiff lacks standing to sue. Therefore, identifying the nature of plaintiff's claims before filing a complaint can help plaintiff's counsel ensure that the client has standing to bring the action and, if applicable, navigate the procedural pitfalls of derivative actions. For defense counsel, on the other hand, recognizing and challenging the plaintiff's lack of standing or his or her failure to comply with the requirements of derivative actions can be an effective method of attacking the pleadings.

What is a derivative suit? A shareholder's derivative suit is an action brought on the corporation's behalf that seeks to recover for the benefit of the corporation and its whole body of shareholders when injury is caused to the corporation that may not otherwise be redressed because of a failure of the corporation to act. *Jones v. H.F. Ahmanson & Co.*, 1 Cal.3d 93, 106-07 (1969). Thus, an action is derivative, "i.e, in the corporate right, if the gravamen of the complaint is injury to the corporation, or to the whole body of its stock and property without any severance or distribution among individual holders, or it seeks to recover assets for the corporation or to prevent the dissipation of its assets." *Id*. at 106. Derivative suits often are based on a breach of fiduciary duty due to mismanagement, misappropriation of corporate assets or other wrongdoing by corporate officers, directors, or controlling shareholders, or for wrongs inflicted against the corporation by third parties. *Vega v. Jones, Day, Reavis & Pogue*, 121 Cal.App.4th 282, 297 (2004) (citation omitted). The shareholder is merely a nominal plaintiff in such an action. *Schuster v. Gardner*, 127 Cal.App.4th 305, 312 (2005). Although the corporation must be joined as a nominal defendant, it is the real party in interest and any recovery usually belongs to the corporation. *Id*. However, the plaintiff shareholder may be reimbursed for litigation expenses incurred in obtaining the recovery for the corporation. *See Avikian v. WTC Financial Corp.*, 98 Cal.App.4th 1108, 1117-18 (2002).[2] Because a derivative action is a suit in equity, the plaintiff does not have a right to a jury trial in state court. *Rankin v. Frebank Co.*, 47 Cal.App.3d 75, 90-92 (1975).

Whether a plaintiff must file derivatively is important not only because any recovery in such suits usually belongs to the corporation and there is no right to a jury trial, but also because of the various procedural hoops the plaintiff must jump through in a derivative action. Before a shareholder can file a derivative suit, the shareholder must exhaust all practical means of forcing the corporation to act. This is done by first informing the directors about the action and requesting that they bring the action or otherwise redress the injury, unless such a demand on the directors would be useless or futile. Under California law, the complaint must allege with particularity the plaintiff's efforts to secure from the board such action as plaintiff desires, or the reasons for not making such effort. Cal. Corp. Code § 800(b)(2). The complaint also must allege that the plaintiff informed the corporation or the board in writing of the ultimate facts of each cause of action to be asserted against each defendant, or that the plaintiff delivered to the corporation or the board a true copy of plaintiff's proposed complaint. *Id*. If a *disinterested* majority of the board makes a *good faith business judgment* that the action is not in the corporation's best interests and thus rejects the shareholder's demand that the corporation bring a lawsuit, then the plaintiff shareholder is barred from maintaining a derivative suit. *Oakland Raiders v. National Football League*, 93 Cal.App.4th 572, 587 (2001). However, the plaintiff is excused from making an effort to obtain relief from the board if he or she alleges and proves that such efforts would have been useless or futile. *Id*. Additionally, a plaintiff in a derivative suit may be required to furnish a bond to secure reimbursement of reasonable litigation expenses incurred by the officer or director defendants (and the corporation itself) if plaintiff does not prevail in the action. Cal. Corp. Code § 800(c).

The requirements for a member's maintaining a derivative action on behalf of an LLC are largely similar to those for derivative suits by corporate shareholders. The

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2. This may be an attractive feature to a plaintiff suing on a tort cause of action such as breach of fiduciary duty, particularly where the potential damage recovery is limited, or whose LLC/Shareholder agreement does not have an attorneys' fee clause.

Congratulations Justice O'Leary

The ABTL Congratulates Justice (and ABTL Board Member) Kathleen O'Leary on receiving the prestigious Benjamin Aranda III Access to Justice Award given by the California State Bar, the Judicial Council and the California Judges Association, in association with the California Commission on Access to Justice for her long-term and tireless commitment to improving access to our courts for all.

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Having incurred fender bruises on both hips, I dusted off my somewhat battered centrist politics and ran for an empty seat on the superior court and was elected in 1986. The only reason I ran for superior court rather than municipal court was that I couldn't afford a municipal court campaign. The smaller district would have required me to take a leave of absence from the District Attorney's Office because personal campaigning can play a big role in such an election; in a countywide race, walking precincts was much less important. So, since I could not afford to take an unpaid leave of absence, I ran for the superior court.

Q: *Which was a more difficult transition: from lawyer to trial judge or from trial judge to appellate justice?*

A: The transition from attorney to trial judge is much tougher. Trial judging is the hardest job in the system – next to criminal defense.

Q: *What advice would you have for the complex business litigators on how to preserve their win or reverse their loss at trial?*

A: So many others have answered this question that the best answers are taken. I would offer this suggestion, however. Look closely at the record you or your opponent has designated. This crucial step is often overlooked; people mistakenly assume everything will be in the record designated. If you leave something out, you can find yourself up the proverbial creek without the proverbial implement.

This is especially important for respondents. When you receive the designation of record, study it closely to make sure your opponent has not – inadvertently – left out testimony or a document or a hearing that is critical to your case. As a general rule, we consider only what is designated as the appellate record, and if it isn't there, it doesn't exist.

Q: *What advice would you give attorneys appearing before the Court of Appeal for the first time, or anytime for that matter?*

A: Oral argument is a time to say what you've already said in a new or different way. You tried to say your piece in a convincing way in the brief. But when you go back to the briefs before oral argument, months removed from their writing, you will almost certainly find things

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you now realize aren't as clear or as forceful as they seemed when you wrote them. Unless you're a different breed of cat than I was (I was an appellate lawyer for most of my career), you should be thrilled by the opportunity to make your positions clearer and more forceful. That's what oral argument is.

And that's *all* it is. You can cite new cases *only* if you've previously notified opposing counsel and you can *never* offer new arguments. But you can offer a new hypothetical, a new comparison, a different way of explaining what you've already said in your briefs. You can find better language in the cases you've already cited (you'll be surprised how often that happens). You can explain in clearer and more forceful terms the flaw in your opponent's reading of some key case. If you're respondent, you can answer the Reply Brief.

You can even offer a more fervent description of the parade of horribles you think will follow hard upon another obtuse and obdurate judicial ruling against you. But I don't recommend this technique: It smacks of desperation.

Q: *What is the biggest mistake attorneys make before you?*

A: The biggest mistake attorneys make before us is failing to understand the answer to the previous question. If you try to make new arguments or sandbag opposing counsel with new case citations, you will be made to feel bad.

Q: *You are quite legendary for your writing, and your monthly column "A Criminal Waste of Space" is always a pleasure to read. How did this column come about and how have you continued (since 1981) to find new and interesting topics?*

A: Kind words noted and appreciated. I don't think I've ever sat down at the keyboard without imagining all the attorneys who must look at the column and think, "Oh jeez, not this guy again! Does he really think he's that funny?" The answer to that question is, "No, I don't think I'm that funny and I'm always amazed that there are people who continue to enjoy it." It's now syndicated into sixteen markets and makes me a nice chunk of cash.

But the main reason for writing it has always been that I enjoy laughing, and I've always had jobs (prosecutor, judge, justice) that provide very little outlet for humor. The column is a safety valve that keeps me from trying to be funny in court. Nobody wants to hear, "Your 5 million dollar judgment is reversed, but did you hear the one about the nun and the parrot and the sailor?" By writing the column, I bleed off any inclination to be a "funny judge."

The column was born in the criminal calendar court in the late seventies. An attorney from Los Angeles was scheduling new dates for his trial and told the judge he wanted to schedule an "oral traverse." A traversal of a search warrant is an unusual motion and I'd never seen one in Orange County. I turned to the prosecutor next to me and whispered, "Oral Traverse, isn't that the evangelist from Oklahoma?" "No," he said, "that's Oral Roberts. An oral traverse is something your dentist charges $500 for."

We spent the rest of the morning making jokes like that and I had so much fun with them that I expanded them into a 25-question multiple-choice exam called "The Criminal Law Specialist and Screendoor Repairman's Examination." I sent it off to the *California State Bar Journal*. It was the first humor they had ever published, and was well-received by people who were apparently pretty desperate for entertainment. The editor of what was then the *Orange County Bar Journal* asked me if I could write a monthly humor column. I said I could as long as someone provided me with advance sheets. And the rest, as they say, is tragedy.

Q: *I understand that you are sought out to speak across the county. Can you tell us a little about that? Where have you been? Where are you going?*

A: I gave a speech to the American Bar Association Bar Presidents Conference in 2001. It was what my wife Kelly and I call the "Stop and Eat the Roses Speech" because it urges people to spend more time enjoying their life and less time making money – don't just smell the roses, eat them. The first person to the podium afterward was the president of the Hawaii Bar Association asking me to give the speech in Hawaii (you can imagine my reluctance). Since then, I've given the speech all over the country. I was in Napa in July and I'm speaking to the American Bar Association's International Law section in London on October 5 and the Nebraska Bar Association on October 19 (this one comes with tickets to the Nebraska-Texas A&M football game the next day). Without this avocation, Kelly and I would never have visited Snake Stabler's legendary *Florabama Lounge and Package Store* in Perdido Key, Florida, which we both recommend highly.

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Q: *What do you enjoy doing when you are not working?*

A: For 13 years, the NHL subsidized my primary hobby by hiring me to work as a goal judge at Anaheim (Mighty) Ducks games. They have now asked me to work the two season-opening NHL games in London, September 29-30, which will make for what I think is an unusual parlay: speaking to the ABA and officiating an NHL game in the same week.

But I'm phasing out the NHL and devoting more time to golf and reading. Kelly and I are doing more traveling now that I'm entering geezerhood and have no kids living at home. (This is the first year I haven't had my daughter's softball to share with her and I greatly miss it.) And, of course, the column eats up a lot of time.

Q: *If you could choose any job in the world other than a judge, justice, or lawyer, what job would you choose?*

A: I have often said if I'd had a decent high school guidance counselor, I'd be doing play-by-play for the Rancho Cucamonga Quakes today. Baseball is my first love. I played in high school and college, and would have kept playing if the NCAA hadn't obtained a restraining order forbidding me from ever playing again. I played softball until my knee surgeries caught up with me. Until then, my dream was to die at the age of 86, trying to go from first to third on a single. Now my dream is just, to borrow from the great Bobby Layne, "to run out of cash and air at the same time."

Thank you Justice Bedsworth for both your time and the laughs. It has been a real pleasure.

▪ *Linda A. Sampson is Of Counsel in the litigation department of Morrison & Foerster's Irvine office.*

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tent of the information and the skill of the panelists, is reason enough to join the organization, there are additional benefits as well. Prior to each of our regular dinner programs, we always have a Judge's reception. This is a unique opportunity to interact with the judiciary on a less formal basis. This is a valuable opportunity to express concerns about the court system and to learn about how the various judges' perceive issues from the benches' perspective. We have been very fortunate to have our programs well attended by the local bench, both state and federal. The one thing I have heard from the various board members is that it is hard to encourage the more junior lawyers to attend the programs and get involved in the organization. There are obvious pressures and newer lawyers are concerned about billing their hours. But the benefits of interacting informally with the judiciary and observing practical programs that are directly related to their practice area and which are presented by the most highly regarded lawyers and judges in the county and state, are unquantifiable.

So, please take advantage of all of the benefits of the organization and renew your next year's membership early. Also, please encourage your firm to sign up its entire litigation department. Finally, I want to encourage you to attend the dinner programs and the annual seminars. The more lawyers and judges that can participate and interact, the more valuable the programs become for all concerned. Thank you for your active participation in the ABTL Orange County Chapter and I look forward to seeing you all at the next dinner program.

▪ *James G. Bohm is a partner at Bohm, Matsen, Kegel & Aguilera.*

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cally cover a three-year period, and will be used to verify that all individuals the employers pays for services properly have been classified as either employees or independent contractors. Furthermore, EDD audit information is made available to the Internal Revenue Service (IRS) under an exchange agreement, and the IRS may use such information in the administration of its tax program (including its own audits of companies doing business in California). Separately, the California Department of Industrial Relations (DIR) has authority to inspect businesses for purpose of reviewing whether an employer is in compliance with the California Labor Code. The DIR has the power to issue stop work orders and penalty assessments against employers the DIR finds have misclassified workers as contractors instead of employees.

Given this oversight, it is important for employers to identify and properly classify workers as employees or independent contractors. This article identifies some of the important aspects of this evolving body of the law.

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A. Tax And Employee Benefit Issues

All employers should be aware of the *Vizcaino*[1] cases — where a class of so-called "freelancers" successfully sued Microsoft on the theory that, because they met the definition of employee under the common law factors set forth in *Nationwide Mut. Ins. Co. v. Darden* 503 U.S. 318 (1992), they were not independent contractors but rather Microsoft employees entitled to the same benefits as full-time Microsoft employees.

In *Vizcaino*, the issue of worker status arose from an IRS audit. Applying common-law principles, the IRS concluded that Microsoft's freelancers were not independent contractors, but employees of Microsoft for employment tax purposes. The IRS required Microsoft to pay withholding taxes and the employer's portion of the Federal Insurance Contribution Act (FICA) tax. After learning of the IRS rulings, Donna Vizcaino and other contractors sued Microsoft in federal court claiming that they were entitled to savings and stock option benefits.

Ultimately, Microsoft settled the case. The settlement required Microsoft to pay nearly $100 million. Microsoft also changed its staffing and worker classification practices, which resulted in Microsoft hiring over 3000 class members as W-2 employees entitled to participate in Microsoft's benefit plans.

1. Employment Tax Implications

The *Vizcaino* cases illustrate that a tax audit can lead to serious independent contractor issues — including a civil lawsuit, steep tax penalties, and employee benefit liabilities. Some of those issues are discussed in greater detail below.

a. Tax Implications Under California

In California, the CUIC defines an "employing unit" is any individual or type of organization that has in its employ one or more individuals performing services for it. An employing unit becomes an "employer" upon paying wages in excess of $100.00 in a calendar quarter to one or more employees. "Wages" consist of remuneration for services performed, including cash payments, commissions, bonuses, and the reasonable cash value of non-monetary payments for services. Once a business becomes an employer, it must complete a registration form within 15 days. Employers also are responsible for reporting wages paid to their employees and paying Unemployment Insurance taxes and Employment Training Tax on those wages, as well as withholding and paying State Disability Insurance taxes and Personal Income Tax due on wages paid to employees.

Under the CUIC, "employment" means "service, including service in interstate commerce, performed by an employee for wages or under any contract of hire, written or oral, express or implied." The term "employee" is defined later in the CUIC, and means any of the following: (i) any officer of a corporation; (ii) any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee; or (iii) any worker whose services specifically are covered by law. By implication, an "independent contractor" is someone who does not meet any of these criteria.

A written contract by itself does not determine an independent contractor relationship: "The terminology used in an agreement between a principal and a worker is not conclusive of the relationship, even in the absence of fraud or mistake." Moreover, according to published guidelines of the EDD, a worker performing services "on a less than full time or permanent basis" can still be an employee for tax purposes. Furthermore, California employment tax law "does not exclude services from employment that are commonly referred to as day laborers, part-time help, casual labor, temporary help, probationary, or outside labor."

The EDD administers California employment tax laws. Section 4304-1 of Title 22 of the California Code of Regulations, defines an employee, and lists the rules generally applicable to common law determinations for employment tax purposes. Under those rules, to determine employee status, the most important factor is "the right of the principal to control the manner and means of accomplishing a desired result." If the business has the right to control the manner and means of accomplishing the desired result, whether or not that right is exercised, an employer-employee relationship exists. The right to discharge a worker at will and without cause is strong evidence of the right of direction and control. But when

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1. *Vizcaino v. Microsoft Corp.*, 97 F. 3d 1187 (9th Cir. 1996), *rev'd in part*, 120 F. 3d 1006 (9th Cir. 1997) (en banc); *Vizcaino v. Microsoft*, 173 F. 3d 713 (9th Cir. 1999), *reh'g denied and opinion amended*, 184 F. 3d 1070 (9th Cir. 2000), *cert. denied*, 528 U.S. 1105 (2000). On December 12, 2000, the parties announced a $97 million settlement, which was approved. *Vizcaino v. Microsoft Corp*, 142 F. Supp. 2d 1299 (W.D. Wash. 2001), *aff'd*, 290 F. 3d 1043 (9th Cir. 2002), *cert. denied*, 537 U.S. 1018 (2002).

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it is unclear whether the business has the right of control over the manner and means of accomplishment, the actual working relationship between principal and worker must be examined. The EDD will look at ten factors to determine whether an employment relationship exists.

Moreover, both the CUIC and Title 22, California Code of Regulations, set forth specific application of the common law rules for specific industries. If a business falls within one of the specific industries, these regulations will be considered when making employee versus independent contractor status determinations involving a type of worker or service. Employers using contingent workers should be familiar with these particular rules and regulations.

Finally, as of January 1, 2001, any business or government entity required to file a Form 1099-MISC for services performed by a "service provider" must submit a "Report of Independent Contractor(s)" to the EDD. That report must be submitted to the EDD within 20 days of either making payments totaling $600.00 or more, or entering into a contract for $600.00 or more with an independent contractor in any calendar year, whichever is earlier. If an employer fails to comply with these requirements, the EDD may assess penalties against the employer.

b. Tax Implications Under Federal Law

On the issue of who qualifies as an "employee" for employment tax purposes, federal law is similar to California law, but not the same. For federal tax purposes, the IRS, like the EDD, follows common law for purposes of determining worker status. Like the EDD, the IRS has published guidelines on how a business can determine worker status. Until 1996, the IRS used a list of twenty significant factors to examine the evidence and identify an employer-employee relationship. The IRS simplified this list when it issued a training manual on worker classifications for IRS agents in 1996 (which the IRS publicly adopted in 1998).

According to published guidelines of the IRS, "[i]n an []employee-independent contractor determination, all information that provides evidence of the degree of control and degree of independence must be considered." The guidelines also state that the IRS will examine three specific aspects of the worker□employer relationship in order to properly classify a worker: (i) the degree of behavioral control an employer can exercise over a worker; (ii) the degree of financial control an employer can exercise over a worker; and (iii) the parties' perceptions of the employer-worker relationship.

Behavioral control. This test focuses on facts that illustrate whether an employer has a right to direct or control how the worker performs the tasks for which the worker is engaged, including the type and degree of: (i) instructions that the business gives to the worker; and (ii) the training that the business gives to the worker.

Financial control. This test focuses on facts illustrating a worker's opportunity to realize a profit or loss. According to the IRS, facts that show whether the business has a right to control the business aspects of the worker's job include: (i) the extent to which the worker has unreimbursed business expenses, (ii) the extent of the worker's investment, (iii) the extent to which the worker makes his or her services available to the relevant market, and (iv) how the business pays the worker.

Type of relationship. This factor focuses on how the employer and worker perceive their relationship to each other. Some facts that illustrate this perceived relationship include the following: (i) the parties' intent (often illustrated by a written contract), (ii) whether an employer provides a worker with employee benefits, (iii) the circumstances under which a business or a worker can terminate the relationship, (iv) whether the relationship is of a permanent and indefinite nature, and (v) whether the worker's services are an integral aspect of the employer's business. If these facts indicate that either party sees the worker as an employee, that perception will weigh in favor of employee status.

To classify workers, the IRS scrutinizes the impact each fact has on the above three aspects of the relationship. The less behavioral and financial control an employer exercises over its contractors and the more both parties perceive those workers as independent contractors, the more likely the IRS would conclude that the parties' arrangement is consistent with independent contractor status.

2. Employee Benefit Implications

The Microsoft case also illustrates the pitfalls in using independent contractors as concerns their eligibility for participation in the employer's benefits plans. In *Vizcaino*, the Ninth Circuit held that the plaintiffs there were entitled to participate in Microsoft's benefit programs notwithstanding the fact that the plaintiffs signed independent contractor agreements. The Ninth Circuit relied on *Darden*, which held that, because the definition of "employee" under ERISA is unclear, a court should apply the "common law" test for employee to determine eligibility for plan membership.

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To determine whether a worker qualifies for benefits under a plan established under ERISA, a court will determine whether the worker is a "participant" in or a "beneficiary" of an ERISA plan. ERISA defines "participant" as "any employee or former employee of an employer . . . who is or may become eligible to receive a benefit of any type from an employee benefit plan . . . or whose beneficiaries may be eligible to receive any such benefit." A worker is a "participant" in an ERISA plan if a two prong test is met: (i) he or she must be a common law employee of the employer maintaining the plan, and (ii) according to the language of the plan, he or she is eligible to receive a benefit under the plan. A worker who fails on either prong lacks standing to bring a claim for benefits under a plan established under ERISA.

Employers using contingent workers should review their plans, and make sure that those workers are not eligible for membership. Employers also should require their contractors to acknowledge in writing that they are not entitled to plan participation. Ultimately, the type and scope of such acknowledgements will depend upon the particular contracting relationships.

B. Liability Under The California Labor Code

Under the Labor Code, California businesses are required to have workers' compensation insurance for their employees. (Labor Code, § 3700.) The DIR has been vested with the power to enforce this requirement, including conducting investigations of businesses, issuing stop work orders, and assessing penalties for perceived Labor Code violations. Large companies, using hundreds (or thousands) of contract workers, could expect huge penalties if the DIR concludes that contingent workers are misclassified as "independent contractors" as opposed to "employees."

Furthermore, the DIR can impose a stop work order against a business the DIR concludes is in violation of the Labor Code. In addition, businesses also could be liable for overtime premiums, meal period pay, and other remedies available to misclassified workers under the Labor Code. Depending upon the extent to which a business has misclassified contract workers, potential liabilities and penalties could be in the hundreds of millions of dollars. Misclassifying workers also could expose a business to: (i) tort liability (see Labor Code, § 3706); (ii) unfair business practices (see Business & Professions Code, § 17200); and (iii) criminal liability (see Labor Code, § 3700.5).

C. Conclusion

Contingent workers may put employers at risk under federal and state law. All employers must be mindful of the rules and regulations governing contractors, as well as the case law and administrative decisions interpreting and applying those rules and regulations. Although no employer can be assured of absolute immunity, there are steps that employers can take to minimize their risks in using contract workers.

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the recognition of its counterparts in Los Angeles. It was a young but rapidly expanding bar, indeed, so young that most of ABTL-OC's current Board of Governors, including current officers James Bohm, Martha Gooding, Richard Grabowski and Sean O'Connor, had not yet been admitted to the bar in 1980: Jim had just graduated from high school; Martha was a law student at Boalt Hall; Richard was an undergraduate at California State University Long Beach; and Sean was, gulp, a freshman in high school!

Although it featured a number of very highly respected judges, including the late Harmon Scoville, the Orange County Superior Court numbered slightly over 40 judges, much less than its neighbor to the north. But it, too, was destined to grow along with the rest of the county, and in the coming years, many talented new judges would join the bench as the court expanded. In 1980, many of these future judges were a long way from the bench. For example, current ABTL-Orange County Board member and Presiding Orange County Superior Court Judge Nancy Wieben Stock was prosecuting criminals in the United States Attorney's Office in Los Angeles; current Board member and Supervising Judge of the Orange County Superior Court Complex Civil Litigation Panel David Velazquez was practicing consumer law with the Legal Aid Foundation of Los Angeles; and, gulp, current Board member and Orange County Superior Court Judge Andrew Banks had just graduated from law school!

But at least there was a state courthouse in Orange County. In 1980, there was no federal courthouse, and the few federal district court judges who lived in Orange County had to commute up the freeway to their court-

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rooms in Los Angeles. And of the current federal district court judges who call Orange County home, in 1980 Judge Alicemarie Stotler was sitting on the Orange County Superior Court bench; Judge David Carter was prosecuting criminals as a Deputy District Attorney in the Orange County District Attorney's Office; Judge James Selna was a partner of O'Melveny & Myers; Judge Andrew Guilford was an associate with Sheppard, Mullin, Richter & Hampton; and Judge Cormac Carney was, gulp, just starting to catch footballs at UCLA!

The practice of law in Orange County in 1980 was not, contrary to the views of the Gibson, Dunn partner who tried to convince me to stay in Los Angeles, minor league. But it was not Los Angeles, and it was still several years away from being invited to become an ABTL chapter. But how things had changed by 1997.

By 1997, Orange County had grown to over two and half million people, over 175 publicly-held companies were headquartered in Orange County, and the county's industry, although still featuring a significant element of real estate development, now included substantial segments of hi tech, healthcare and finance as well. The legal community had grown too. Most of the Los Angeles-based firms had opened Orange County offices, as had firms from Northern California (Howard, Rice, Nemerovski, Canady, Falk & Rabkin and Pillsbury, Madison & Sutro among them), and even the Midwest (Jones, Day among them). And Orange County law offices were growing. By 1997, Latham and O'Melveny had over 60 attorneys, Gibson more than 70, Knobbe, Martens over 80, and Rutan had almost 90 lawyers by 1997.

The Orange County bench had also seen significant growth. The Superior Court now had over 60 judges, and planning was under way for a pilot Complex Civil Litigation Panel. The county also now had its own federal courthouse, albeit housed in a trailer (the Ronald Reagan Federal Building and United States Courthouse was under construction, but would not open for another year), with three sitting federal district court judges: Judges Stotler, Carter, and Gary Taylor.

So, it was not surprising, indeed it was long overdue, when ABTL invited Orange County to start its own ABTL chapter in 1997. Those of us practicing law in Orange County knew full well the quality and depth of the Orange County legal community. That quality and depth not only guaranteed the immediate and resounding success of ABTL-Orange County, it has provided the organization with very capable leadership in the years that followed.

Where does this leave us in 2007? For those of us who call themselves business trial lawyers, we continue to go toe-to-toe and face-to-face with the best lawyers in America. Orange County lawyers are recognized throughout California and the Nation as among the best, something anyone who has tried a case against an ABTL-Orange County lawyer knows full well.

This point was brought home to me recently. This past year, I had the good fortune to represent an Orange County-based company in two international arbitrations, one in London and the other in Stockholm, involving a series of contractual disputes between our client and its Russian supplier regarding the sale of non-weapons grade uranium to Republic of Korea utilities. In both arbitrations, my Newport Beach colleagues and I went up against prominent lawyers in two well-know international firms, who had years of experience handling international arbitrations. In the early going, our adversaries responded to virtually anything we suggested with a common refrain: "We don't do ***that*** in international arbitration." However, as the matters proceeded, more often than not, the Tribunals, which were composed of some of the most highly respected arbitrators in the world, sided with our view of things. And, at the evidentiary hearings, we did what Orange County business trial lawyers do: we told our client's story, and we did it well enough to win both arbitrations.

For those of us who are lucky enough to practice law in Orange County, we have known for years that Orange County is not Omaha, that it is not the minor leagues -- it never was. Since 1997, ABTL has provided to Orange County lawyers the opportunity to demonstrate to those outside of our community the high quality of the lawyers and judges, and the breadth of the legal practice, in Orange County. I am confident that ABTL will continue to provide this opportunity in years to come.

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Hafif, Don Martens, Stephen Neal, Pierce O'Donnell and Tom Stolpman, as well as esteemed judicial officers such as: Bill Rylaarsdam, Glenda Sanders, Alicemarie Stotler, Gary Taylor, Tom Thrasher, Jack Trotter and Stu Waldrip. Our Orange County Chapter has never looked back since, and the quality of our dinner programs has continued to impress and educate through the years.

In addition to holding regular dinner programs, all of the ABTL Chapters in California also regularly convene each year for the ABTL Annual Seminar. Although each ABTL Chapter contributes representatives to the Annual Seminar Committee, only one Chapter is given the primary responsibility each year to run the show and assure success. Our Orange County Chapter was given the stewardship of chairing both the 2002 Annual Seminar and the 2006 Annual Seminar. Each of those events turned out to be a tremendous success.

The 2002 Annual Seminar took ABTL to the Big Island of Hawaii for the first time, and was set at the beautiful Mauna Lani Bay Hotel on the Kohala Coast. True to form (just like our ongoing dinner programs), that event came off splendidly and received rave reviews for its power-packed program, entitled "Winning at the Beginning: The Battle for Injunctive Relief." Four years later, the 2006 Annual Seminar then ably carried on the Orange County tradition of success. Held at the spectacular Grand Wailea Resort on Maui -- and owing a huge debt of gratitude to guiding force Gary Waldron -- that event again reminded everyone of the highly professional quality produced by Orange County. The program was entitled "When Things Go Wrong," and not only diagramed numerous challenges which could confront the business litigator, but also provided ample advice and assistance to help resolve such a panoply of potential problems.

All of us can certainly be proud of the established tradition for excellent educational events that our Chapter's first ten years have fostered, and can undoubtedly look forward to a continuation of that tradition for many years to come under our present and future leaders.

▪ *Jeffrey W. Shields is the principal of Shields Law Offices in Irvine and was the Orange County Chapter's fifth President.*

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Planning oriented engagements for income tax, estate tax, gift tax, mergers and acquisitions, and personal financial planning.

The AICPA has carved out a number of exceptions to SSVS. These exceptions help define the applicability of this statement and they are as follows:

Exceptions to SSVS[2]

- Audit, review and compilation engagements
- Use of values provided by the client or a third party
- Internal use assignments from employers to employee members not in the practice of public accounting
- Engagements that are exclusively for the purpose of determining economic damages (for example, lost profits) and that do not include an engagement to estimate value
- Mechanical computations that do not rise to the level of an engagement to estimate value
- Engagements where it is not practical or reasonable to obtain or use relevant information and, therefore, the member is unable to apply valuation approaches and methods described in this Statement. Engagements meeting the jurisdictional exception

The exceptions noted by the AICPA are included in the "General Interpretation" section of the SSVS and are broad in nature. The AICPA also provides specific illustrations of various engagements fact patterns. See below:

Illustrative Engagements [3]

	SSVS No. 1 Applies	SSVS No. 1 Does Not Apply
Engagements to estimate value.	√	

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2. SSVS No. 1- Interpretation No. 1 - 01

3. CPA Expert, Summer 2007, Volume 13, Number 1. Published by the American Institute of Certified Public Accountants

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plaintiff must have been a member of the LLC at the time of the transaction, or otherwise meet the qualifications set forth in California Corporations Code Section 17501(a)(1). The member's complaint must allege with particularity the plaintiff's efforts to secure action from the managers (instead of the board in the case of shareholder derivative suits, or the reasons for not making such effort. Cal. Corp. Code § 17501(a)(2). The complaint also must allege that the plaintiff informed the LLC or the managers in writing of the ultimate facts of the plaintiff's proposed causes of action or delivered to the LLC or the managers a true copy of plaintiff's proposed complaint. *Id*.

Given these requirements, the critical question arises: When must a dispute among the shareholders or members of a business organization be brought as a derivative action rather than a direct action? California appellate case law is divided on this issue, at times straining to excuse the plaintiff from filing derivatively where the court believes that to do so would be a waste of time. In particular, recent appellate decisions suggest that courts may endeavor to find a reason to permit a direct action in cases involving close corporations or limited liability companies which typically have fewer members. [3]

Direct Shareholder Actions

In the seminal case of *Jones*, *supra*, the California Supreme Court held that a plaintiff shareholder can bring a direct action to enforce a right that he or she possesses as an individual, even where the injury to the plaintiff shareholder is not unique to that plaintiff, so long as "the injury is not incidental to an injury to the corporation." 1 Cal.3d at 107-08. Some cases have described the test articulated in *Jones* as an "exception" to the requirement that a shareholder must bring a derivative action in the name of the corporation. *PacLink*, *supra*, 90 Cal.App.4th at 964; *Rankin v. Frebank Co.*, *supra*, 47 Cal.App.3d 75, 95 (1975).at 95.

Whether a plaintiff shareholder can state an individual action or must bring a derivative action is determined from the gravamen of the wrong alleged in the pleadings. *See, e.g.*, *Jones*, 1 Cal.3d at 106-07; *PacLink*, 90 Cal.App.4th at 965; *Nelson v. Anderson*, 72 Cal.App.4th 111, 124 (1999). Plaintiff's counsel seeking to file a direct action should bear this in mind when crafting the allegations of the complaint.

Since the Supreme Court's 1969 decision in *Jones*, appellate cases have either applied *Jones* to permit an individual action, or distinguished *Jones* and required that the shareholder's action be brought derivatively, depending on the gravamen of the wrong alleged in each particular case.

Cases Permitting A Direct Action

Common examples of direct actions include suits brought to compel declaration of a dividend or the payment of lawfully-declared or mandatory dividends, to enjoin a threatened *ultra vires* act, or to enforce shareholder voting rights. *Schuster*, *supra*, 127 Cal.App. at 313 (citation omitted). Such actions clearly involve a wrong to the shareholder, as opposed to the entity. Decisions permitting an individual action – primarily First District and Sixth District cases – involved situations where it was clear that the value of the corporation was not harmed by the actions of the majority shareholder(s) and either the plaintiff shareholder was injured by giving up some right or property unique to him when forming the corporation, or the majority shareholder(s) obtained some benefit, such as a tax benefit or the opportunity to purchase shares of a holding company, which benefited the majority shareholder(s) and was not afforded to the plaintiff.

Thus, in *Crain v. Electronic Memories & Magnetics Corp.*, 50 Cal.App.3d 509 (1975), the court permitted the minority shareholder plaintiffs to bring a direct action based on allegations that the majority shareholder and the board of directors engaged in self-dealing in depriving the plaintiffs of their ownership interests in the business without compensation by rendering the minority shares valueless. The defendant exercised its control over the company to sell the entire business and its assets to a third party for cash and to loan the cash back to itself in return for an unsecured promissory note payable to the company. The minority shareholders of the company sued the majority shareholder alleging that the effect of the transaction was to leave the company as a shell corporation with an unsecured note as its only asset. The court explained that a direct action was appropriate because the defendants engaged in "self-enriching" activities that generated substantial cash for defendants' own purposes as a result of the sale of company assets, while locking plaintiffs into a shell corporation with valueless minority shares. *Id.* at 521-22.

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3. For a discussion of derivative and direct actions in the context of a limited partnership, see *Everest Investors8 v. McNeil Partners*, 114 Cal.App.4th 411 (2003).

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In *Smith v. Tele-Communication, Inc.*, 134 Cal.App.3d 338 (1982), a parent corporation filed a consolidated tax return with its subsidiary while it was in the process of liquidating the subsidiary. This had the effect of appropriating tax benefits to the parent corporation while reducing the distribution to the plaintiff who was the sole minority shareholder of the subsidiary corporation. The court permitted the plaintiff to bring a direct action because he did not claim that there was an injury to the subsidiary corporation itself or any resultant depreciation of the value of its stock (which would have been a derivative claim). Rather, the gravamen of the plaintiff's claims was the injury to plaintiff as the only minority shareholder. *Id*. at 343.

Other cases have permitted an individual action where the court found that the wrong predated the entity. In *Sutter v. General Petroleum Corp.*, 28 Cal.2d 525 (1946), defendants had an oil lease from the state for certain tide and submerged lands and owned drilling equipment on the leased property. The plaintiff alleged that defendants, through false representations and promises, induced him to organize and finance a corporation to take over the lease and the equipment and abandon his other plans to develop oil lands in the same area, and defendants misrepresented that the equipment had been constructed soundly. The plaintiff formed the corporation and expended significant time and effort in the venture, but subsequently discovered that the equipment was defective, and that because defendants were unable to get their oil lease assigned to the corporation, the lease was cancelled by the state, defendants refused to supply their expert assistance or rent the drilling equipment, and the venture and its stock became worthless. *Id*. at 526-29.

The *Sutter* court explained that "[g]enerally, a stockholder may not maintain an action in his own behalf for a wrong done by a third person to the corporation on the theory that such wrong devalued his stock and the stock of the other shareholders, for such an action would authorize multitudinous litigation and ignore the corporate entity." *Sutter*, 28 Cal.2d at 530. But an action is individual "if the injury is one to the plaintiff as a stockholder and to him individually, and not to the corporation, as where the action is based on a contract to which he is a party, or on a right belonging severally to him, or on a fraud affecting him directly . . ." *Id*. The court also stated that "a stockholder may sue as an individual where he is directly and individually injured although the corporation may also have a cause of action for the same wrong." *Id*. (citations omitted). The court allowed the plaintiff to bring an individual action because he was induced to form the corporation and abandon other projects, so the fraud was against him as an individual and was committed before the corporation was formed. *Id*. at 530-31.

A more recent case that permitted a direct action for similar reasons is *Denevi*, *supra*. The plaintiff in *Denevi* was a member of an LLC with a 20 percent ownership interest in the company. The court held that a plaintiff could bring both a derivative and a direct action where they are based on different sets of facts. *Id*. at 1218-19. The facts giving rise to the direct action that was permitted in *Denevi* involved the plaintiff being defrauded into giving up rights that he had prior to the formation of the LLC to purchase real property, which he was fraudulently induced to then transfer to the LLC. *Id*. In permitting the direct action to proceed, the court noted that the injury arose *before* the formation of the LLC, at the moment defendants induced him to part with his purchase rights, and did not depend on the plaintiff's status as a member. *Id*. at 1218-19, 1222.

<u>Cases Requiring That The Action Be Filed Derivatively</u>

Numerous California appellate court decisions since *Jones* – primarily Second and Fourth District cases – have held that in situations where the plaintiff shareholder alleged that the defendant officers, directors, and/or majority shareholders fraudulently transferred corporate assets to another entity, misappropriated corporate opportunities, and/or mismanaged the corporation, the gravamen of the complaint was injury to the corporation, or the injury affected all of the shares of the corporation's stock. As a result, because the claims were derivative in nature and the plaintiff lacked standing to bring an individual action. To the extent there was any individual injury to the plaintiff shareholder in these cases, it was incidental to the injury to the corporation. Typically, the plaintiff's alleged injury in such cases was alleged to be the diminution in the value of the plaintiff's shares or the lost profits of the corporation.

In *Avikian v. WTC Financial Corp.*, 98 Cal.App.4th 1108 (2002), for example, the gravamen of the complaint by the plaintiff shareholders was their assertion that the defendant officers and directors mismanaged or looted corporate assets, and entered into self-serving deals to sell assets to third parties, culminating in the corporation's involuntary liquidation. *Id*. at 1115. The court

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held that the claims were derivative, stating, "Those assertions – both the improper selling and purchasing of assets – amount to a claim of injury to [the corporation] itself . . . [Plaintiffs'] own damages, the loss in value of their investments in [the corporation], were merely incidental to the alleged harm inflicted upon [the corporation] *and all its shareholders*." *Id*. at 1115-16.

In *PacLink*, *supra*, the court likewise held that the plaintiffs could not assert a direct action based on allegations of a fraudulent transfer of corporate assets. *Id*. at 965. *PacLink* involved an eight-member limited liability company of which the plaintiffs owned 38 percent. *Id*. at 961. The assets of the company were transferred to a new company that was organized by four members of the original LLC but in which plaintiffs had no involvement, ultimately rendering the original LLC insolvent. *Id*. at 961-62. The plaintiffs alleged that the assets of the original LLC were transferred without their knowledge or consent; that initially the transferees gave no consideration for the assets; that several hundred thousand dollars was subsequently paid to other members of the LLC for the assets but none of that money was ever distributed to plaintiffs; and that the assets were passed through dummy entities owned by the individual defendants. *Id*. at 961. At issue on appeal were plaintiffs' causes of action against the transferee companies for fraudulent transfer, conspiracy to defraud creditors and commit conversion, and imposition of a constructive trust. *Id*. at 962.

The court held that the "exception" described in *Jones* to the requirement that a shareholder bring a derivative action was inapplicable to the case because the essence of plaintiffs' claim was that the assets of the LLC were fraudulently transferred without compensation, which constituted an injury to the company itself. *PacLink*, 90 Cal.App.4th at 964. *Id*. In applying the principles of corporate derivative suits to an eight member limited liability company, the court explained:

> Because members of the LLC hold no direct ownership interest in the company's assets . . . the members cannot be directly injured when the company is improperly deprived of those assets. The injury was essentially a diminution in the value of their membership interest in the LLC occasioned by the loss of the company's assets. Consequently, any injury to plaintiffs was incidental to the injury suffered by [the LLC].

Id. at 963-64. The court further explained that "[a]n individual [stockholder] may not maintain an action in his own right . . . for destruction of or diminution in the value of the stock . . . ." *Id*. at 965 (citing *Rankin*, *supra*, 47 Cal.App.3d at 95). The court concluded that the plaintiffs' causes of action were improperly pled as individual causes of action. *Id*.

In *Rankin*, the majority shareholders of a company transferred the manufacturing portion of the business to a newly formed corporation owned by the majority shareholders of the company but in which the minority shareholders had no interest. 47 Cal.App.3d at 80. The plaintiffs alleged that they were unaware they did not own any interest in the new corporation, or that the majority shareholders of the company received any benefit from the new corporation. *Id*. The court held that the minority shareholders had no individual right of action for the diversion of corporate assets because the gravamen of their case was injury to the corporation, and the wrong suffered by the plaintiffs was incidental to that injury. *Id*. at 95. The court fashioned a remedy, however, which equitably distributed the damages recovered in the plaintiffs' derivative action. *Id*. at 96.

Nelson, *supra*, involved a closely-held corporation formed for the purpose of marketing skin care products and consisting of only two shareholders: the plaintiff, who was the minority shareholder, and former actress Loni Anderson, who was the majority shareholder. The plaintiff alleged that Anderson breached her fiduciary duty in connection with the marketing of the skin care products by, among other things, failing to use the plaintiff in telemarketing spots. The plaintiff alleged that this resulted in the failure of the corporation, which in turn caused the plaintiff to lose her capital investment and prospective corporate profits. The plaintiff's alleged damages included economic damages in the form of the corporation's lost profits as a result of corporate opportunities that were rejected by Anderson, as well as damages for emotional distress. 72 Cal.App.4th at 125-26.

The court found that all of the acts alleged by the plaintiff amounted to mismanagement of the corporation's business, causing it to be total failure, and, that any obligations violated by Anderson were duties owed directly and immediately to the corporation. *Nelson*, 72 Cal.App.4th at 125. Accordingly, the court held that because the gravamen of the complaint was injury to the whole body of the corporation's stockholders, relief could only be sought by the corporation, or the plaintiff

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in derivative action if the corporation refused or failed to act. *Id*. at 126. The court also held that because the injury was to the corporation and the plaintiff did not allege any breach of a duty owing to her personally, her emotional distress and the loss of her investment were incidental to the injury to the corporation. *Id*. With respect to the lost profits to the corporation as a result of corporate opportunities rejected by the majority shareholder, the court explained that as a shareholder, the plaintiff had no ownership in the profits of the corporation and thus could not have been deprived of them. *Id*. at 126. The court added that "[a] lost opportunity to increase corporate assets or net worth is the most common situation in which a derivative action is the only appropriate remedy." *Id*. (citation omitted).

Other cases, involving mismanagement by the officers, directors, and/or majority shareholders, have similarly refused to permit the plaintiff shareholder to assert an individual action. *See Schuster*, *supra*, 127 Cal.App.4th at 314 (defendants allegedly mismanaged corporation by overstating assets and understating expenses); *Pareto v. FDIC*, 139 F.3d 696, 700 (9th Cir. 1998) (9th Circuit, applying California law, held that the plaintiffs lacked standing to assert a direct action against corporate directors for breach of the duties of care and loyalty arising out of the liquidation and merger of their bank because the alleged mismanagement affected the whole of the bank's assets, and injury to the value of the individual shareholder's shares was incidental to the injury to the corporation's assets).

Equitable Considerations In Cases Involving Close Corporations Or LLCs With Few Members May Cause Courts To Either Permit A Direct Action Or Allocate Recovery To The Plaintiff In A Derivative Action

As close corporations and LLCs increasingly are used as a form of business organization, courts will more often face the problem of how to apply the principles of derivative actions to these entities. The analysis applied in case law involving larger corporations and business entities may result in certain inequities when applied in the context of a small corporation or LLC with concentrated ownership, in which the majority owners usually also comprise at least a majority of the board, making it more likely that a demand on the board would be futile and that wrongdoing by management or the majority shareholders or owners will have a direct impact on the minority owners. In the few cases that have addressed this situation, two different approaches have emerged. One approach has been to adhere to the requirement that the action be filed derivatively (perhaps aware that the plaintiff should have little difficulty pleading and proving demand futility) but note that courts can use their equitable powers to allocate some direct recovery to the plaintiff. The other approach has been to strain to find a reason to permit the plaintiff to proceed in a direct action in an effort to short circuit a demand procedure that likely would be a waste of time and to better protect the recovery by the individual plaintiff. This approach accounts for the fact that the individual plaintiff's recovery is more difficult to separate in derivative actions, where the recovery is diluted to the extent the plaintiff's recovery is shared with the corporation and ultimately benefits all shareholders alike – including the majority shareholders who may have been defendants in the lawsuit.

The first approach was used by the court in *Nelson*, *supra*. Even though the case involved a close corporation consisting of only two shareholders, the court required – consistent with prior case law – that the action be filed derivatively because it was readily apparent that the crux of plaintiff's allegations was that the majority shareholder failed to do certain things which, according to the plaintiff, would have made the company more profitable. As such, the injury clearly was to the corporation itself, and the plaintiff's injuries – lost profits that would have inured to her through increased share value and her emotional distress resulting from the alleged mismanagement – were incidental to the injury to the company. However, recognizing the inequity that would result if the recovery was had by the corporation and the majority shareholder was allowed to share in that recovery, the *Nelson* court explained that the court could equitably distribute any damages so that the majority shareholder would not, in effect, be paying damages to herself. *Nelson*, 72 Cal.App.4th at 127; *see also Rankin*, *supra*, 47 Cal.App.3d at 96 (equitable distribution of damages in shareholders' derivative action).

In contrast, another recent case demonstrates that equitable considerations may cause courts to strain to allow the plaintiff to file a direct action in the context of a close corporation. In *Jara v. Suprema Meats, Inc.*, 121 Cal.App.4th 1238 (2004), plaintiff, the sole minority shareholder in a close corporation consisting of only three shareholders, brought suit against the two majority shareholders. The plaintiff claimed that the two majority shareholders breached their fiduciary duty to him by paying themselves excessive compensation, and that as a result he was deprived of a fair share of the corporation's

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profits.

Noting that there is "some tension" between *Smith* and *Crain*, on the one hand, and *PacLink* and *Rankin*, on the other hand, the First District in *Jara* elected to follow the *Smith* and *Crain* line of cases and permitted the plaintiff to bring a direct action. The court likened the facts of *Jara* to *Jones*, in which the court allowed a minority shareholder to bring a personal action alleging "a majority stockholder's breach of a fiduciary duty to minority stockholders, which resulted in the majority stockholders retaining a disproportionate share of the corporation's ongoing value." *Jara*, 121 Cal.App.4th at 1257-58. The court also found support for its holding in two other cases that involved excessive compensation and permitted a direct action, *De Martini v. Scavenger's Prot. Ass'n*, 3 Cal.App. 2d 691 (1935) and *Low v. Wheeler*, 207 Cal.App.2d 477 (1962).

The *Jara* court's reasoning suggests the court was quite willing to be flexible in permitting the plaintiff to bring his claims in an individual action. For instance, the court recognized that the alleged payment of excessive compensation "did have the potential of damaging the business," but dismissed this point by concluding that there was no real injury to the company because as a factual matter the company was growing and prosperous despite the payment of the excessive compensation, and the plaintiff did allege that the company would have experienced even more growth and prosperity but for the defendants' excessive compensation. *Jara*, 121 Cal.App.4th at 1258. Additionally, although the plaintiff alleged he was deprived of "a fair share of the corporation's profits," the court interpreted the complaint as merely seeking a share of "disguised dividends" paid to the majority shareholders in the form of excessive compensation, a characterization more akin to allegations that give rise to a direct action. *Id.* at 1242, 1259-60.

Significantly, the *Jara* court further reasoned that the policy considerations favoring derivative actions were inapplicable to the case. First, the court found that the justification for requiring derivative actions of preventing multiplicity of actions by each individual shareholder and assuring equal treatment for all aggrieved shareholders does not arise at all where there is only one minority shareholder. *Jara*, 121 Cal.App.4th at 1258-59. Second, the court concluded that the objective of intracorporate resolution of disputes and protecting managerial freedom which underlies the requirement that plaintiffs submit a demand to the board of directors before filing suit is "entirely meaningless" where the defendants constitute the entire board of directors and all of the corporate officers. *Id*. at 1259. Third, the court found that the policy of preserving corporate assets for the benefit of creditors has at best a very weak application where the corporation remains a viable business. *Id*.

Whether other Courts of Appeal will follow the approach taken in *Jara* or in *Nelson* to other types of shareholder suits involving close corporations remains to be seen. Although *Jara* held that the plaintiff could bring his claims in a direct action under the particular facts of that case, it did not purport to announce any general rule applicable to all cases involving close corporations. In fact, in discussing *Nelson*, the *Jara* court did not even mention the fact that *Nelson* involved a close corporation consisting of only two shareholders, nor did it disagree with the holding in *Nelson*. Rather, *Jara* expressly distinguished *Nelson*, as well as *Avikian* and *PacLink*, on the ground that they involved corporate mismanagement or fraud instead of the payment of excessive executive compensation. *Jara*, 121 Cal.App.4th at 1255, 1258. Furthermore, the grounds relied upon in *Jara* to distinguish its facts from the typical derivative action would seem to apply in many if not most close corporations/LLCs.

The application of *Jara* to other situations may be limited in several other respects. The fact that *Jara* involved a single minority shareholder and the defendants comprised the entire board were critical to the court's decision. The court in *Jara* expressly relied on these facts to find inapplicable the policy considerations favoring derivative actions. Thus, courts may not follow *Jara* where the company at issue has several minority shareholders (not all of whom are plaintiffs or support the lawsuit) and/or where the defendants do not constitute the entire board of directors or all of the officers. In those situations, the policies of avoiding multitudinous litigation and promoting intracorporate resolution of disputes may support requiring that that an action be filed derivatively. Certainly, there is a better chance in those scenarios for the internal resolution of corporate disputes without judicial intervention than the situation where all of the shareholders/members are either on one side of the case caption or the other.

Conclusion

Whether a shareholder or a member of a limited liability company can sue management or other owners directly, or must comply with the requirements for suing derivatively on behalf of the corporation or LLC, depends on how the plaintiff pleads his claims. The complaint

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may be subject to attack on the ground that the plaintiff lacks standing to sue. Generally speaking, a shareholder may bring a direct action where, for example, the plaintiff seeks to compel payment of a dividend; to enjoin threatened *ultra vires* acts; to enforce shareholder voting rights; in situations where the plaintiff was induced to give up or forego a right or property he or she possessed as an individual; or where the majority shareholders manipulated stock or obtained some other benefit such that they retained a disproportionate share of the value of the corporation at the expense of the minority shareholders. By contrast, shareholder actions in which the plaintiff's core claim consists of mismanagement, self-dealing, misappropriation of corporate assets or opportunities, or cases in which the plaintiff's alleged damages consist of the diminution in the value of his or her shares or lost corporate profits, must be brought by the corporation itself or in a derivative action.

However, shareholder lawsuits do not always fit neatly into these various categories, and precedent can be particularly difficult to apply to close corporations or LLCs with few members. While this area of the law as applied to business organizations with concentrated ownership and/or management is still developing, the few courts that have addressed such situations, depending on the nature of the plaintiff's allegations, have either: (i) adhered to the requirement that the action be filed derivatively where it was clear that the injury was to the corporation and any individual injury was incidental to the injury to the corporation, but equitably distributed the damages so that there is no recovery to the wrongdoers (as in *Nelson*); or (ii) strained to find a basis in the allegations for an individual injury where it was clear that a demand on the board would be pointless, and questioned the applicability of the policy considerations favoring derivative actions to the facts alleged by the plaintiff (as in *Jara*). Courts may yet fashion other solutions as they grapple with ever-increasing disputes among shareholders and members of LLCs.

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	SSVS No. 1 Applies	SSVS No. 1 Does Not Apply
Lost-profits damage computations.		√
Economic damages computations that incorporate a terminal value.		√
Lost value of a business or intangible asset damages calculations.	√	
Mechanical calculations of value (for example, using actuarial tables), for which valuation approaches and methods are not used and professional judgment is not required.		√
Valuing a relatively small block (relative to the total amount of the corporation stock outstanding) of publicly traded stock when the per-share price is readily ascertainable.		√
Preparing a tax return using a valuation of a business that was provided by a third-party appraiser or by the client.		√
Calculating case "hold back" requirements for tax contingencies.		√

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	SSVS No. 1 Applies	SSVS No. 1 Does Not Apply
Valuing for any purpose (including estate tax return preparation) a block of publicly traded stock if the analysis includes consideration of a discount for blockage, lock-up, or other contractual or market restrictions such that valuation approaches and methods are applied, and professional judgment is used to determine the value.	√	
Valuing stock that is not publicity traded.	√	
Computing the fair market value of assets in a charitable remainder trust (CRT) if the engagement requires the application of valuation approaches and methods and the use of professional judgment.	√	
Valuing nonpublicly traded limited partnership interests.	√	
Providing advice for planning purposes (such as estate planning, personal financial planning, or merger and acquisitions planning) without reference to value.		√
Providing advice for planning purposes (such as estate planning, personal financial planning, or merger and acquisitions planning) where the member calculates value.	√	

	SSVS No. 1 Applies	SSVS No. 1 Does Not Apply
Determining the tax deductibility of interest under a non-recourse Loan.		√
Compliance filings that require an estimate of the value of a company, and the value estimation requires the application of valuation approaches and valuation methods and the use of professional judgment.	√	
Compliance filings that require an estimate of the value of a company, and the client or a third-party appraiser provides thevalue of the subject interest.		√
Compliance filings that require an estimate of the value of a company, and the state (or other government agency) follows formula rules for which the application of valuation approaches or methods is not necessary.		√
Purchase price allocations in which the value to be allocated is a subject interest (that is, a business, business ownership interest, security, or intangible asset), and the client or a third party did not provide the member with the value of those assets.	√	
Purchase price allocations in which, after the allocation of the purchase price to cash, receivable, inventory, and depreciable tangible assets, there is a mechanical assignment of the residual amount to goodwill or going concern value.		√

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	SSVS No. 1 Applies	SSVS No. 1 Does Not Apply
Purchase price allocations in which the member allocates a residual amount to specific intangible assets (such as to various customer-based or supplier-based intangibles), and such allocation is based on the asset's relative value.	√	
Computing the fair market value of an interest in a family limited partnership (FLP) for tax purposes without applying any valuation discount.	√	
Computing the fair market value of assets in, or computing the required distribution of, a charitable remainder trust (CRT) where the CRT holds assets in which valuation requires the application of valuation approaches and methods and the use of professional judgment, such as an interest in a limited liability corporation (LLC).	√	
Computing the fair market value of assets in, or computing the required distribution of, a charitable remainder trust (CRT) where the CRT only holds publicly traded stock with a readily ascertainable value.		√
Asset value assignment valuation engagements under IRC Section 704(c) when (1) one or more of the assets is a business, business ownership interest, security, or intangible asset (2) the client or a third party does not provide the valuation, and (3) the member applies valuation approaches and methods and uses professional judgment to value these assets.	√	
Cost segregation study to allocate the costs of building a structure between the real property and personal property components of the structure.		√
Planning for income from discharge of indebtedness under IRC Section 108 when (1) the company must rely on the insolvency provisions of IRC Section 108 (2) one or more of the assets for which value is relevant under IRC Section 108 is a subject interest (that is, a business, business ownership interest, security, or intangible asset), (3) the company or a third party does not provide the valuation, and (4) the member applies valuation approaches and methods and uses professional judgment to value the subject interest(s).	√	
Valuing a partnership interest when the client and the member agree that the member will apply an "average" valuation discount that the member will determine based on the results of published discount studies and case law.	√	
Informal conversation or written communications with a client regarding the alternative tax consequences of gifting versus selling a business using a presumption of a specific value of the business.		√
A transfer pricing study (IRC Section 482) that involves the use of specific methodologies, data, terminology, and documentation requirements that are provided in the IRS regulations and procedures, and where methodologies and documentation requirements differ from those contained in SSVS No. 1.		√

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	SSVS No. 1 Applies	SSVS No. 1 Does Not Apply
Settlements or negotiations of value in offers-in-compromise or tax disputes.		√
Determining the value of accounts receivable.		√
Determinations of value of a member employed in industry, government, or education who "moonlights".	√	
Assignments from an employer to an employee member not in public practice to prepare a valuation for internal financial reporting purposes.		√
Personal financial planning services that include estimating the proceeds from a hypothetical future sale of the client's business Interest.		√
Personal financial planning services that include (1) estimating the proceeds from a hypothetical future sale of the client's business interest, (2) the client or another party provides the current value, and (3) the member does not apply valuation approaches and methods.		√

	SSVS No. 1 Applies	SSVS No. 1 Does Not Apply
Personal financial planning services that include estimating the proceeds from a hypothetical future sale of a client's business interest, including a general discussion with the client of valuation concepts or industry pricing multiples based on the member's industry knowledge, where the discussion assists the client in determining. a hypothetical or assumed value.		√
Preparing a personal financial plan that includes an estimate of the future proceeds from a sale of the business interest at retirement, where the member estimates the future proceeds based on an estimate of the business's current value developed by applying a rule of thumb multiple for the subject industry but the member does not consider the risk factors of the subject interest or exercise other professional judgment in applying the rule of thumb multiple		√

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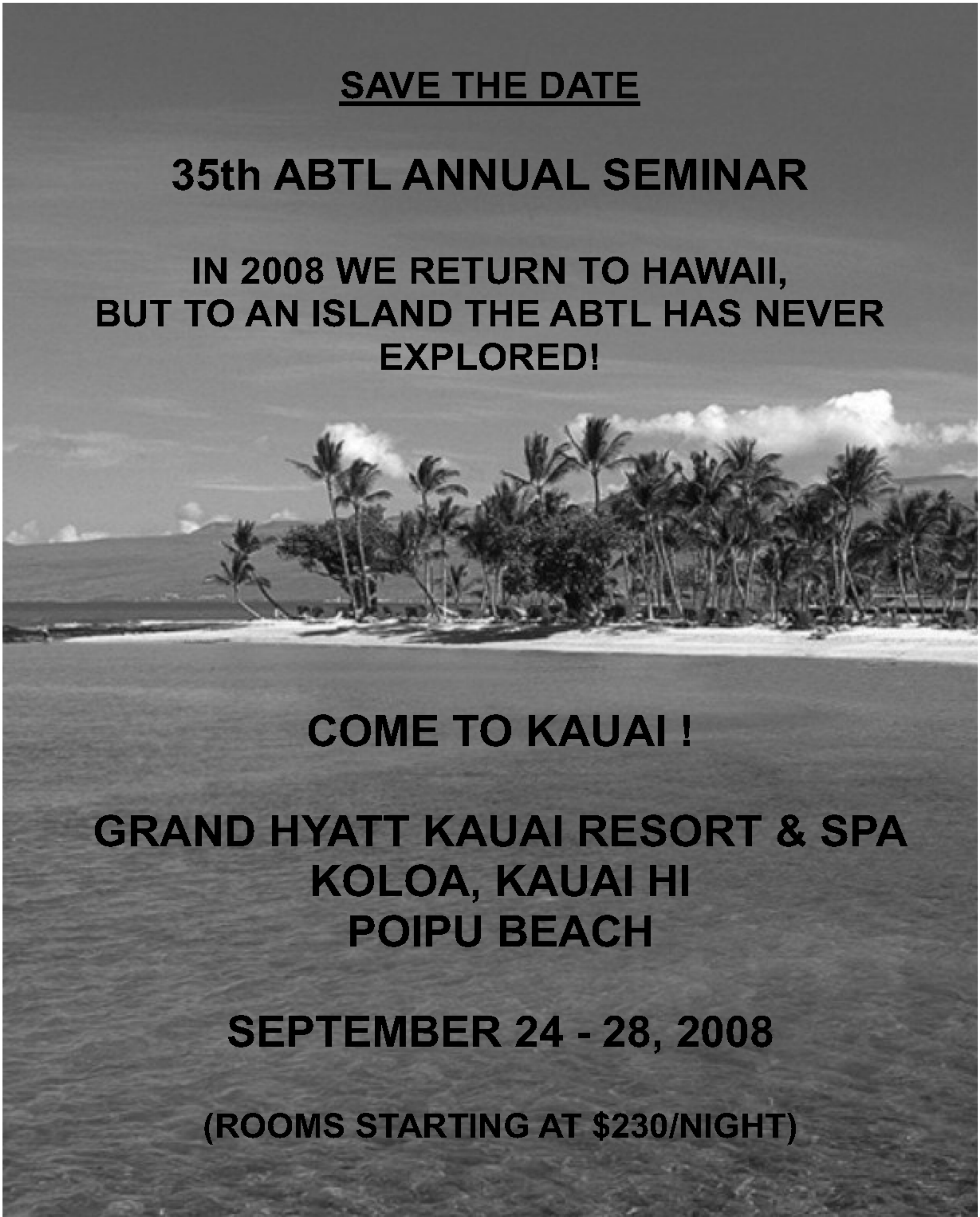
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