Reish Luftman Reicher & Cohen
Attorneys at Law

BUSINESS AND TAX

ADVISOR REPORT

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Message From The Firm

Doing business in California can involve many legal and tax hazards and hurdles. This newsletter discusses three issues we have dealt with in our business practice that demonstrate such hazards and hurdles.

Jon Karp's article discusses one of the potential pitfalls a client faced during the sale of its business in California as a result of the differences in the federal and California WARN acts. Jon also provides a creative solution to the problem that satisfied the law without creating additional transaction costs for either the buyer or the seller.

In the second article, Gary Wexler summarizes a recent Supreme Court case involving the inducement of at-will employees to quit their current employment to come work for a competing company. Gary's article points out that the mere solicitation and/or hiring of a competitor's employee is not actionable in California, however, a defendant may be held liable if the solicitation was coupled with an independent unlawful action. Unfortunately, the Court did not specify what that unlawful action was, therefore, one needs to exercise great care in the hiring of a competitor's employees.

California Usury laws regulate the maximum amount that can be charged on a loan. These rules are very complicated and may apply even if the lender or the borrow didn't know the interest rate exceeded the maximum amount prescribed by law. Although there are many exceptions to the Usury laws, the definition of interest is broader than you might think. If the law applies, a borrower has several remedies against the lender.

As always, if you have a question about an article in this newsletter, please contact the author or me.

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Don't Forget to "WARN" in California

By Jonathan Karp (JonKarp@Reish.com)

Problem: One consequence of selling the assets of a business may be the relocation and/or termination of many, if not all, of the seller's employees. If not properly handled, this can result in significant unanticipated expense to the seller. A business client recently sold their assets to another company, which was considering hiring many, but not all, of the seller's 80 full and part time employees. Since the buyer wanted free rein to decide which employees to hire, it required the seller to fire all the employees on the closing. However, in order not to disrupt the business operations prior to the sale and to keep the transaction confidential, the seller did not want to inform employees that the sale was occurring until the closing date. Under this scenario, the seller was liable to pay its employees 60 days wages as a result of their termination.

Solution: Because the buyer and seller were on cooperative terms, we were able to restructure the transaction to allow the employees to remain employed by the seller for 60 days after the closing and have the buyer "lease" those employees from the seller, reimbursing the seller for all costs associated with these employees. This arrangement saved the seller from the obligation to pay 60 days wages for terminated employees, and didn't cost the buyer any additional money.

Discussion: The Federal Worker Adjustment and Retraining Notification (WARN) Act and its California counterpart, California Labor Code Sections 1400-1408 require 60 days advance notice if there will be a loss of employment for a significant number of employees.

In our client's situation, the federal law, which applies to "business enterprises" that employ more than 100 full time employees, would not apply. Even if our client's business met this criteria, the federal WARN act excuses the seller from compliance with the law assuming the buyer hires substantially all of the employees after the close. The burden of compliance is shifted to the buyer.

Unfortunately, the California WARN Act differs in significant ways from the Federal WARN Act. First, it applies to businesses with 75 or more employees, and doesn't exclude part time employees. Second, and worse from the seller's point of view, California has no corresponding "shift of liability" provision. The California WARN Act is silent on what happens if the buyer assumes employment of the seller's employees. Although our client was not required to comply with the Federal WARN Act due to the number of affected employees, it was subject to the California WARN Act. Under the literal interpretation of the California WARN Act, the seller is responsible for giving 60 days

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Company Held Liable for Inducing Competitor's Employee to Quit

By Gary Wexler (GaryWexler@Reish.com)

Recently, the California Supreme Court unanimously ruled in *Reeves v. Hanlon* that a defendant "may be held liable for intentional interference for having induced a competitor's at-will employee to quit and join the defendants" if the plaintiff proves that the defendant engaged in an independently wrongful act – i.e., an act "proscribed by some constitutional, statutory, regulatory, common law, or other determinable legal standard."

The Supreme Court re-emphasized that one commits no actionable wrong by merely soliciting or hiring the at-will employee of another. It is only when the defendant's solicitation is accompanied by an independently wrongful act that there may be liability for intentional interference.

In so ruling, the Supreme Court rejected a year 2000 Appellate Court decision in *Gab Business Services, Inc. v. Lindsey & Newsom Claim Services, Inc.,* which held that a company could not sue for interference with its at-will employment contracts, even if the company had legitimate claims for breaches of fiduciary duty and unfair competition. In *Gab*, the Appellate Court noted a lack of case law allowing employers, as opposed to employees, to file tortious interference claims and declined to "expand" the tort to include employer claims as inviting innumerable lawsuits and thereby undermining California's public policy supporting mobility and betterment of employees and as chilling employment opportunities.

In *Reeves*, the Supreme Court disagreed with the ruling in *Gab* and held that inducing the termination of an at-will employment relationship may be actionable under the general standard applicable under all claims for intentional interference with prospective economic advantage. The Supreme Court concluded that adopting this standard of recovery in the context of at-will employment relations was particularly appropriate because not only will it guard against unlawful methods of competition in the job market, but it will promote public policies supporting the right of at-will employees to pursue opportunities for economic betterment and the right of employers to compete for talented work. The Supreme Court found it strikes the "proper balance between society's interest in fostering robust competition in the job market and its interest in protecting against unlawful methods of competition."

The facts in *Reeves* were particularly egregious. It was either undisputed or there was substantial evidence that nine employees who had left plaintiff's company, including the six who joined the defendant, had employment relations that they could terminate at-will; that defendants "mounted a campaign against the [plaintiff company] involving destruction of computer records, misuse of confidential information and unethical conduct, of which the cultivation of employee discontent was only a component. This campaign unfairly impaired the [plaintiff's company's] ability to retain its employees; and that the record contained substantial evidence that plaintiffs incurred expenses, well-above the historical baseline for employee recruitment to mitigate damages." The Court concluded that defendants "did not simply extend job offers to plaintiff's at-will employees. Rather, defendants purposefully engaged in unlawful acts and crippled plaintiffs' business operations and caused plaintiffs' personnel to terminate their at-will employment contracts...."

It remains clear after *Reeves* that one commits no actionable wrong by merely soliciting or hiring the at-will employee of another. However, a defendant may be held liable under an intentional interference theory for having induced an at-will employee of a competitor to quit working and join the defendant. Inducing the termination of an at-will employment relations may be actionable under the general standard applicable to claims for international interference with prospective economic advantage. Accordingly, to recover for a defendant's interference with an at-will employment relation, the plaintiff must prove that the defendant engaged in an independently wrongful act. The Supreme Court did not clearly define what is an "independently wrongful act" since there the conduct was so egregious. The independently wrongful conduct was defined as "an act proscribed by some constitutional, statutory, regulatory, common law, or other determinable legal standard."

Reeves does not define all the rules of the game for employers. However, clearly there are certain things one cannot do when soliciting an at-will employee of another. The law is now clear, however, that a company may be held liable for intentional interference for inducing a competitor's at-will employees to quit and join the company if the company engaged in an independently wrongful act.❖

Usury: A Weapon or a Tool

By Jonathan Karp (JonKarp@Reish.com) and Adam Cohen (AdamCohen@Reish.com)

Problem: A business owner is approached by one of his largest long term customers, who claims to be experiencing financial difficulties and requests a short term loan of $100,000. The customer promises to repay $112,000 in six months and threatens to take his business elsewhere if the business owner won't loan him the money. The business owner, facing the loss of a major customer if he doesn't make the loan, agrees to do so. Amazingly, the customer repays the loan as scheduled. However, one week later, the customer calls the business owner and says that he found out this loan was usurious and states that he will be seeking the recovery of $36,000, as damages for the usurious loan. Must the business owner pay the customer $36,000?

Solution: Unfortunately, in this case, the business owner must pay the customer $36,000. California's usury laws, contained in Article XV, Section 1 of the California Constitution, are very intricate and complicated and are borrower oriented, although there are many exceptions to the general rules; to ignore these rules is to risk the entire loss of income or the capital laid out.

Discussion: California's Usury Law regulates the maximum amount of "interest" which may be charged on any loan or forbearance of money at the time the loan is made. In other words, it restricts a lender's freedom to enter into loan arrangements that call for interest in excess of the maximum legal rate.

Generally, the maximum rate of "interest" a lender can charge is (i) 10 percent for money, goods or things used primarily for personal, family or household purposes, and (ii) for other loans, the higher of 10 percent or 5 percent plus the Federal Reserve Bank of San Francisco's discount rate on the 25th day of the month preceding the earlier of the date the loan is contracted for or executed. California courts have deemed "interest" to include anything of value that is received directly or indirectly by the lender from the borrower regardless of the nature or form of the consideration-such as fees, bonuses, commissions, and other miscellaneous charges.

Many loans bear interest greater than 10 percent; why aren't they subject to these same rules? There are numerous constitutional and statutory exemptions to these interest limitations. Banks, credit unions, pawnbrokers, and issuers of credit cards are a few examples of these exceptions.

A frequent question arises relating to payment terms (for example, 2 percent/10, net 30). These terms indicate that there is a two percent discount for payment within 10 days on the amount due a vendor for payment within 10 days, with the full amount due if it is not paid within those two days. Does that constitute usury? The answer is no, since usury only applies if there is a "borrowing or lending or forbearance of money," which is not present under these circumstances.

A loan will be deemed to be usurious when it can be shown that the interest charged exceeds the maximum amount prescribed by law, regardless of whether or not the lender realized that such interest was usurious. In the event that a loan is deemed to be usurious, a borrower is generally provided with the following several cumulative remedies: (1) the borrower can bring an action for money has and received to collect the past interest paid during the two year period prior to the filing of an action; (2) the borrower can seek to recover damages equal to three times the interest paid during the one year period prior to the filing of a lawsuit; (3) the borrower can recover a judgment to cancel all future interest that will become due for the remainder of the term of the loan; and (4); in appropriate cases, where the lender's conduct is oppressive, fraudulent or malicious, the borrower may be able to recover punitive damages.

Additionally, any violation of the usury laws may be a violation of Business & Professions Code Section 17000, et. seq., which would expose the lender to criminal liability. The result is that a usurious loan may turn into an interest free loan and subject the lender to potentially costly damages and potential criminal liability. However, the lender is still entitled to receive payment of the principal amount of the loan, can retain any security for the loan and can enforce the security for the collection of the loan.

If you are a borrower, you should examine all loans received from non financial institutions to determine whether the usury laws can be used for your economic benefit.

Therefore, a simple loan can turn into a disastrous event, even if there was no actual intent to violate the usury laws. Before borrowing or, more importantly, lending money, you should consider the impact of the usury laws on the transaction. A little bit of planning and forethought can save hefty legal bills and headaches. ❖

WARN in California

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advance warning before the closing date. If it doesn't give that warning, and all the employees are terminated on the close of the sale, the seller must pay employees 60 days wages, even if they get another job (and that job could be with the buyer). Furthermore, at least one court has held that the purchaser of the business may be responsible for compliance with the California WARN Act if it hires these employees and then terminates them in a short period, perhaps due to a relocation of the business operations. In the extreme case, employees could receive an unexpected windfall of 60 days wages from the seller upon their termination, normal wages for any work they did for the buyer after the closing and another 60 days wages from the buyer upon termination. Due to the ambiguity in California, both the purchaser and seller should be aware of their potential liability if they fail to give employees 60 days notice prior to termination.

Penalties for failure to give notice can be severe and costly. Under both WARN Acts, the penalty for failure to give adequate notice is back pay to the employee for each day he or she was entitled to notice, for a maximum of 60 days. Also, the employee may be entitled to any benefits they would have received if they had been employed during the advance notice period. Along with the penalties to be paid to the employee, the employer will also be required to pay a civil penalty of $500 day for each day that the employee failed to give notice to the requisite local government. This includes, but is not limited to, the Employment Development Department, the Local Workforce Investment Board, or the chief elected official of the affected city and county.

One way to avoid incurring these penalties is to deal with them in advance. Our solution for our client was to structure an employee leasing agreement. As of the sale of the business, the seller continues employment of the employees and lease them to the buyer for the requisite 60 day period. Notice of termination should be given to the employees and the required regulatory agencies and government agencies at the start of the 60 day period. This arrangement will protect both the seller and the purchaser by complying with the provisions of the California law. Another solution, at least from the seller's perspective, is to structure the transaction as a sale of stock rather than a sale of assets. Since the corporation being sold would continue to employ the employees, there would be no termination to require notice or payment. While stock sales have significant tax advantages for sellers, there are corresponding tax disadvantages for the buyer. These are beyond the scope of this article, but provide one more reason why sellers may want to structure the transaction as a stock sale.

In conclusion, although there are many considerations when deciding to purchase, sell or merge businesses, one important and costly mistake that can be made is ignorance of the provision of the California WARN Act. Just because the transaction is exempt from the federal WARN Act does not mean that California's law won't come into play. Creative solutions, such as those we utilized for the above described client, can minimize a seller's liability under the California WARN Act. ❖

Confiscatory New California Tax on Punitive Damage Awards

California Governor Arnold Schwarzenegger has signed into law a new 75 percent tax on punitive damage awards with respect to cases filed on or after August 16, 2004 and which becomes final (including resolution of all appeals) before July 1, 2006.

The law, new Civil Code section 3294.5, provides that California and the plaintiff's attorney are to split 75 percent of the punitive damage award (one-quarter of which is payable to the attorney and the remaining amount retained by the State). The plaintiff is to receive 25 percent of the total award, subject to the plaintiff's fee agreement with his or her attorney (typically a one-third contingency fee). For example, of a $1 million punitive damage award, California could receive $562,500 (three-fourths of the 75 percent tax on $1 million), the plaintiff's attorney could receive $270,833 (one-quarter of the 75 percent tax on $1 million, plus a one-third contingency fee on the 25 percent received by the plaintiff) and the plaintiff could receive only $166,667 (two-thirds of 25 percent of $1 million).

The law was purportedly enacted to address California's "extraordinary and dire budgetary needs" and is anticipated by State budget officials to yield $450 million in tax revenue. However, the new tax would not apply to a situation where plaintiffs and defendants settle their dispute and characterize the ultimate award as other than punitive damages. This possibility can create a conflict of interest between the plaintiff's attorney and his or her client because the attorney will likely receive a larger fee if the award is subject to the new tax, while the plaintiff will likely receive a larger amount if settlement proceeds avoid the tax.

Around the Firm

Jon Karp was recently elected to serve as Vice President of the Los Angeles Chapter of the California Society of CPAs for the 2005-2006 term. Jon previously served as Treasurer.

Brad Cohen gave a seminar on "Current Developments in Transfer Tax Law" to business managers in Los Angeles in May. Jon spoke to accountants in Santa Monica in May on "Ten Biggest Mistakes in Selling a Business." Jon also gave presentations on "Debriefing Tax Season" to the CPA/Law Forum on May 24th in Los Angeles and on May 26th in Pasadena.

Mark Terman will be speaking on "Managing the Workplace to Avoid Employee Claims" on June 15th to the Management of Accounting Practice Committee of the Los Angeles Chapter California Society of CPAs. Jon will be speaking in July at the California CPA Education Foundation's Pass-Through Entities Conference in Los Angeles and San Francisco. In August, Jon will be teaching an all day course in Monterey for the CPA Education Foundation on "Succession Planning for the CPA Firm." In September, Brad will be a co-presenter with Mike Foster at the CPA Education Foundation's Entertainment Industry Conference and Jon will speak at the CPA Education Foundation's Succession Planning for the CPA Firm Conference.

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