QWarterly Chronicles

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You Be the Judge

In early 2004, VL Systems, Inc. (VLS), a software consulting company, contracted with Star Trac Strength (Star Trac) to assist in migrating to a new server. The job was quoted at $185 per hour and the time estimated for the job was 16 hours. The contract contained a provision under which Star Trac agreed that it would not attempt to hire VLS personnel during the term of the contract and for 12 months after completion. The contract provided for liquidated damages of 60% of the new annual compensation of any employee of VSL who is hired by Star Trac in violation of the contract. The clear purpose of the restriction was to deter the customers of VSL from using its services, identifying a good software consultant, and hiring away that consultant. The agreement was signed on behalf of Star Trac by Anthony Stella, its information technology manager.

VSL hired David Rohnow as a consultant in April, 2004, after the project for Star Trac was completed by VSL. He was one of approximately ten consultants employed by VSL at the time. In June, 2004, Stella gave notice to Star Trac of his intent to leave the company, but agreed to stay on until his position was filled. The job was posted on the internet and Rohnow responded. The management of Star Trac was aware of the restriction in the contract with VSL, but believed it was inapplicable because Rohnow did not work on the project for Star Trac and was not even employed by VSL at the time the work was performed. Rohnow was hired and began working for Star Trac on September 20, 2004.

VSL shortly thereafter sent an invoice to Star Trac for $60,000.00 based on the claimed breach of the agreement. Star Trac declined to pay the invoice and VSL thereafter filed suit. The trial court agreed with VSL that Star Trac's action breached the contract. However, the court did not agree that the liquidated damages provision was reasonable to apply in the case of an employee who had not been employed for less than six months and had not received training from VSL. The court awarded VSL $28,500. Star Trac appealed.

What do you think the outcome was in the appellate court? Was the restriction enforceable? If so, should it be applied under these facts?

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The Pension Protection Act of 2006: Its Effect on IRAs

The Pension Protection Act of 2006 (the PPA) was the first comprehensive pension legislation passed in the past 30 years. In addition to the changes in charitable giving (as discussed in my article in the Winter 2007 newsletter), the PPA also affected IRAs. Some of the more important changes to IRAs include:

Direct Contributions from IRAs or Roth IRAs to Qualified Charities

Individuals aged 70 ½ or older can distribute up to $100,000 of the IRA or Roth IRA balance to charitable organizations through 2007 without recognizing income. The effect of this change is to allow qualified taxpayers to donate money to a qualified charity from their IRA and Roth IRA accounts. Qualifying distributions are tax-free and are not subject to the penalty on early withdrawals. However, since a qualifying distributions is not included in taxable income, individuals cannot claim a tax deduction for the charitable contribution. This change applies only to outright lifetime transfers from an IRA or Roth IRA, not to testamentary transfers from such accounts or distributions from qualified plans.

Rollovers by Nonspouse Beneficiaries

Prior to the PPA, nonspouses could not roll over an inherited 401(k) plan into their own IRAs. Nonspouse beneficiaries were often forced to pay tax on large distributions within a short period of time following the death of the deceased individual from whom the 401(k) was inherited. However, spouses have long been able to roll over the deceased spouse's 401(k) into their own IRA and defer this immediate taxation.

Effective for distributions made after December 31, 2006, nonspouse beneficiaries may make a direct transfer of any portion of a deceased individual's eligible retirement plan to an IRA established for the purpose of receiving the distribution. This IRA is a completely separate IRA from any IRA owned by the beneficiary. Such an IRA is treated as an inherited IRA, and benefits must be distributed in accordance with the required minimum distribution rules that apply to inherited IRAs of nonspouse beneficiaries. If the nonspouse beneficiary transfers money to an existing IRA, the nonspouse beneficiary will be liable for tax on the entire 401(k) distribution. Spouses can roll over an inherited 401(k) plan into their existing IRAs without owing the tax on such distribution.

Direct Deposits of Tax Refunds to IRAs

For tax years beginning after December 31, 2006, the PPA requires the IRS to make a form available for use by individuals so they can direct some or all of their tax refund into an IRA.

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Don't squat with your spurs on.

Have You Achieved Asset Protection with Your Estate Planning Documents or Business Entities?

As our society has become more litigious, clients have begun to focus on how to protect their assets in the event of unexpected lawsuits which could result in adverse judgments. There are numerous structures which can be used for estate planning and for business planning which also may provide certain levels of asset protection. A client's liability with respect to his business endeavors might be limited by using particular business structures. Some business entities provide only minimal creditor protection while others can provide far broader and greater protection for a client's assets.

One of the most frequently asked questions by clients creating revocable living trusts is whether or not the family trust will provide them with asset protection in the event of a lawsuit. Unfortunately, the answer is no. The living trust is an estate planning vehicle. It enables clients to avoid probate upon death or conservatorships in the event of incapacity. It can ensure ongoing asset management, deal with estate tax issues, and specify the manner of distribution of assets to family members or other heirs. What it does not provide is asset protection for the trustor. Since the trust is revocable by the trustor, all of the trust assets may be reached by the trustor's creditors. Various business and investment structures are often used by clients to accomplish business, tax and estate planning goals. All of the structures have different degrees of asset protection.

A general partnership may be used by two or more persons to accomplish a business or investment purpose, but it does not provide the general partners with protection against the partnership's creditors. Not only would each general partner be fully liable for one hundred percent of the debts of the partnership, but his own personal creditors may be able to reach his partnership interest. A properly drafted partnership agreement can help to avoid the creditor becoming a partner in the partnership. However, the creditor is often able to become an assignee of the debtor/ partner, entitled to receive all of such partner's distributions from the partnership.

With a limited partnership, there is asset protection for the limited partners with regard to the liabilities and debts of the partnership. The limited partners do not participate in the management of the partnership's affairs or control its assets, and have no personal responsiblity for payment of the liabilities and debts of the partnership. The general partner has no such limited liability and is fully liable to the creditors of the limited partnership for all of the limited partnership liabilities and debts. If the limited partner has a personal creditor, the creditor may be able to obtain a charging order against the partnership interest of the debtor/ limited partner. A charging order directs that the creditor is to receive the distributions that would otherwise be made to the debtor/ limited partner. Partnership Agreements generally have provisions which will prevent the creditor of a limited partner from becoming a substituted partner.

Limited liability companies, referred to as LLC's, provide limited liability to all of its members. LLC's are often member managed, but they may also be managed by one or more manager's who may or may not be members. Neither the members nor the managers are personally liable for the liabilities and

Please see "Asset Protection" continued on page 4

If you haven't much education, you must use your brain.

"Asset Protection" continued

debts of the limited liability company. Furthermore, the membership interest of a member in a limited liability company is generally not reachable by his creditors. Many states provide that the charging order is the exclusive remedy available for such a creditor.

Doing business as a corporation rather than as an individual enables the shareholder to avoid becoming personally responsible for the liabilities and debts of the business. However, it is very important that the corporation complies with all of the required corporate formalities and is properly capitalized to prevent a creditor from "piercing" the corporate veil and reaching the assets of the shareholder. When a corporation has been properly structured and managed, the recovery of its creditors will be limited to the assets of the corporation, even in the corporation files for bankruptcy. This would not be the case for a business owned and operated by an individual. Corporations can also provide asset protection for the shareholder by insulating the business owner from certain risks. For example, if a former employee brings an unlawful termination suit against his employer, and is awarded a substantial judgment, the corporate employer will be liable to the extent of the corporation's assets. However, if the employer was simply a business owned by an individual, there would be no corporate shield to protect the individual; all of his assets could be made available to pay the judgment.

If a person creates an irrevocable trust for the benefit of children or other beneficiaries, the assets transferred into that trust will be protected from the creditors of the trustor, so long as the transfer of the assets into the trust is not a fraudulent conveyance. Because the trust is irrevocable, the assets transferred into the trust are deemed to be a gift, and no longer belong to the estate of the trustor. They would no longer be available for attachment by the creditors of the trustor. However, if the trustor transfers all of his assets into an irrevocable trust with the result that he is then insolvent and unable to pay his debts, his creditors could claim that the transfer was a fraudulent conveyance. If this is the case, the assets of the trust could be reached. In California , there is a four-year statute of limitations with regard to fraudulent conveyances. Four years after the date of the transfer, the assets would no longer be available to a creditor even if a charge of fraudulent conveyance is then raised. It is important to keep in mind that the transfers to an irrevocable trust are considered to be gifts. Once a gift is made, it cannot be taken back by the transferor. For this reason, placing assets in a trust for children is not always the ideal solution for asset protection. Additionally, there are certain tax limitations on the amount of tax-free gifts that can be made. Most clients to not want to pay gift taxes on the assets transferred to trusts for children or other third-party beneficiaries.

The ideal asset protection vehicle may well be the asset protection trust. This is a self settled trust, created in a jurisdiction that prevents creditors from attaching trust assets transferred to an irrevocable trust for which the trustor is a beneficiary. Most states, including California , permit creditors to reach the assets of an irrevocable trust if the trustor of the trust is also the beneficiary. Asset protection trusts are commonly set up in "offshore" jurisdiction such as the Cook Islands or Belize . However a handful of states, such as Delaware, have adopted statutes which provide for the creation of asset protection trusts. These statutes normally require that the trustee be

located within the state where the trust is being established. Furthermore, the state's statute of limitations with regard to fraudulent conveyances has to expire before assets transferred to the trust would be fully protected.

For more information about this topic, please contact one of the attorneys at Quinlivan Wexler LLP.

Jacqueline M. Jensen

Office Hours:
Our normal office hours are 8:30 a.m. to 5:30 p.m. Monday through Friday, Saturday by appointment only.

Closures:
Thursday, November 22 and Friday, November 23 for Thanksgiving

Monday, December 24 and Tuesday, December 25 for Christmas

Monday December 31 and Tuesday January 1 for the New Year

"IRAs" continued

Hardship Withdrawals

An employee may take early withdrawals from a qualified plan for hardship if the distribution is made due to the employee's immediate and heavy financial need and the distribution is necessary to satisfy that need. Distributions are deemed to be made due to an immediate and heavy financial need if they are used for:

- Paying medical expenses that were previously incurred by, or are necessary for the medical care of, the employee, the employee's spouse or the employee's dependents;
- The costs directly related to the purchase, excluding mortgage payments, of the employee's principal residence;
- Paying tuition, related educational fees and room and board expenses for the next 12 months of post-secondary education for the employee, his or her spouse, children or dependents; and
- Paying amounts necessary to prevent eviction of the employee from his or her principal residence or to prevent foreclosure on the mortgage on the employee's principal residence.

The PPA modifies the rules relating to hardship discharge to provide that if an event, including the occurrence of a medical expense, constitutes a hardship under the plan if it happens to the participant's spouse or dependant, the event must, to the extent permitted under a plan, constitute a hardship if it happens to a person who is a beneficiary under the plan with respect to the participant.

The effect of this change is to substantially enlarge the number of people on whose behalf a hardship distribution can be made since it includes beneficiaries of the plan who are not qualifying children or qualifying dependents, as dependent is defined in the Internal Revenue Code.

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About Quinlivan Wexler LLP

Patrick "Rick" C. Quinlivan and **Danniel "Danny" J. Wexler** bring almost 50 years of combined legal experience to Quinlivan Wexler LLP. With careful selection and addition of talented professionals to the firm, QW has grown over the years to the point where we now boast of many specialty areas to suit the needs of our clients.

Located near South Coast Plaza, QW engages in a general civil practice that includes civil litigation, business and corporate law, estate planning, probate, conservatorships and elder law.

The breadth of our litigation experience assures our clients' representation by lawyers who fully understand the techniques, not only of trial advocacy, but of negotiations and persuasion as well. So, while being very meticulous about doing our homework, planning ahead, and writing precise contracts to prevent litigation, we are also fully prepared to litigate when it is in the best interests of our clients.

"Ruling"

The appellate court reversed the ruling of the trial court. The court found that the contract provision that sought to prevent Star Trac from hiring personnel employed by VSL violated California Business & Professions Code section 16600. This statute prohibits, with very limited exceptions, an agreement that restrains the right of a person to engage in a lawful profession, trade , or business. Because the provision in this case sought to prevent Star Trac from hiring someone employed by VSL, it had the effect of restraining the employee of VSL from working for Star Trac and was therefore void. The court noted that it is proper to contractually prohibit a party from *soliciting* the employee of another in an attempt to hire that employee. But it cannot preclude a party from hiring the employee of another if that employee initiates the contact. Thus, the provision in this case was void. Note also that even a properly drafted agreement could not have prevented Star Trac from hiring Rohnow because Rohnow initiated the contact in response to a general listing on the internet.

Patrick C. Quinlivan