Insurance Defense Tips Newsletter

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CALIFORNIA SUPREME COURT DE-PUBLISHES COURT OF APPEAL CASE WHICH TWISTED INSURANCE DEFENSE COUNSEL'S ETHICAL DUTIES

By Matthew Trostler, Esq.

In June, the Court of Appeal decided the case of *Schaefer v Elder* which disrupted more than 20 years of precedent regarding the ethical duties of defense counsel appointed by insurers to represent their insureds. In the *Schaefer* case, Schaefer sued Elder for a variety of claims arising out of a construction defect action. Elder tendered the defense of the action to its insurer Castle Point, which appointed defense counsel subject to a reservation of rights, as some of the claims were not covered under the policy. Castle Point filed a separate declaratory relief action against Elder to determine whether the insurance policy provided coverage for the claims Schaefer made against Elder. Elder hired a different law firm and moved to disqualify insurance defense counsel and to determine Elder's right to *Cumis* (independent) counsel. The trial judge disqualified insurance defense counsel and determined that Elder had a right to *Cumis* counsel at the insurer's expense. The insurer appealed.

The Court of Appeal not only affirmed the trial judge's holdings, but also held that insurance defense counsel representing an insurer's insured had an ethical duty to establish facts that would assist the insurer in defeating coverage. One of the issues in the *Schaefer* case was whether Elder's workers were employees or independent contractors. The Appellate Court held that insurance defense counsel not only had an ethical duty to establish that the workers were employees (to Elder) but at the same time had an ethical duty to Castle Point to establish that the workers were independent contractors. This conflict supported the trial court's determination that Elder had the right to *Cumis* counsel and that the insurer provided attorneys were properly disqualified.

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Mercifully, the California Supreme Court granted a petition to de-publish this opinion. The Court of Appeal in *Schaefer*, in holding that insurance defense counsel has an affirmative duty to establish facts to eliminate insurance coverage created an ethical obligation not consistent with defense counsel's primary obligation to fully and zealously represent the interests of an insured. Avoiding coverage issues is one of the prime directives of insurance defense counsel. Participating in discovery which would defeat coverage, especially in circumstances where a reservation of rights letter has been issued, is contrary to protecting an insured's interests. Had the *Schaefer* opinion remained published and therefore precedent, the obligations of insurance defense counsel would have changed to such an extent that it would arguably make it impossible for defense counsel to accept the defense of any case where there might be a coverage question. For now, however, insurance defense counsel in California can continue to rely on the *Cumis* counsel statute and 20 years of case law defining ethical obligations in order to fully represent their clients while simultaneously servicing insurers.

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Labor & Employment Law Newsletter

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Employees to Exhaust All Administrative Remedies Before Filing Suit

By Jonathan P. Geen, Esq.

On August 27, 2013, the Court of Appeal for the Third District issued a very favorable decision for employers with regard to exhaustion of administrative remedies. In *MacDonald v. State of California* (2013) 219 Cal. App. 4th 67, the Third District affirmed the trial court's sustaining of a demurrer without leave to amend on the employee's claim for retaliatory and discriminatory discharge in purported violation of California Labor Code sections 1102.5 and 6310. The basis for the trial court and Court of Appeal's decision was the employee's failure to have taken advantage of the administrative remedy provided to employees by California Labor Code section 98.7. This statutory section provides in pertinent part:

> Any person who believes that he or she has been discharged or otherwise discriminated against in violation of any law under the jurisdiction of the Labor Commissioner may file a complaint with the division within six months after the occurrence of the violation.

The plaintiff employee worked for the State of California, specifically the California State Assembly at one of its offices in San Joaquin County. After being hired, plaintiff complained to supervisors that one of his supervisors was illegally and/or inappropriately smoking at defendant's office, in violation of the California Labor Code. One of the supervisors told plaintiff that the smoking issues were a serious problem and would "be addressed." Nonetheless, less than two weeks later, plaintiff was fired. Plaintiff filed a complaint, setting forth causes of action for retaliatory discharge, in violation of section 1102.5, and retaliatory and discriminatory discharge, in violation of Labor Code section 6310. The plaintiff had not taken advantage of the administrative remedies set out in Labor Code section 98.7, whereby he could have filed a claim with the labor commissioner.

Plaintiff asked the Third District to review the decision of the trial court sustaining a demurrer to plaintiff's complaint without leave to amend his claims because the plaintiff argued that the administrative remedy set out in section 98.7 was permissive and not mandatory, and was meant to

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merely add to the potential remedies available to an aggrieved employee. In rejecting plaintiff's position and in reaching its decision, the Third District focused significantly on the California Supreme Court's decision in *Campbell v. Regents of the University of California* (2005) 35 Cal.4th 311. The *MacDonald* court reiterated the rule of exhaustion of administrative remedies referenced in the *Campbell* case and which it stated was well-established in California jurisprudence. This rule is that where an administrative remedy is provided by statute, relief must be sought from the administrative body and this remedy exhausted before the courts will act. The *MacDonald* court, most significantly, said that **this rule of administrative remedy exhaustion applies even where the administrative remedy is couched in permissive, as opposed to mandatory, language**. The Third District rejected plaintiff's arguments that other appellate decisions controlled, stating that there is no requirement that a plaintiff pursue the Labor Code administrative procedure prior to pursuing a statutory cause of action. The Third District noted that these other cases did not reference *Campbell* and the Third District believed *Campbell* was dispositive on the issue, even though the *Campbell* court never addressed California Labor Code section 98.7. The Third District explained that because the administrative remedy at issue in the case before it was provided by statute, the *Campbell* case controlled and plaintiff was required to exhaust that remedy before filing suit.

This is a very favorable decision to employers. Many employees may not exhaust their administrative remedies before filing suit, and then will have their claims barred. However, it is unclear whether this decision will be followed by other districts and/or whether this is a legal issue the California Supreme Court may see fit to review.

Recent Appellate Decisions

By Jonathan P. Geen, Esq.

Federal

In the case of ***Lawler v. Montblanc North America, LLC*** (9th Cir. 2013) 704 F. 3d 1235, the Ninth Circuit affirmed summary judgment in favor of the luxury writing instrument defendant on the plaintiff's claims for disability discrimination and intentional infliction of emotional distress. The Lawler court determined that the plaintiff was unable to set out a prima facie case because she could not establish that she was competently able to perform her job duties as store manager since, after having broken her toes, she was unable to work more than 20 hours per week, which did not allow her to perform all of the obligations of her job. In fact, the plaintiff had admitted that her disability made it impossible for her to fulfill all the duties of her position, and that she had been unemployed and not applied for any positions for a period of months due to her medical issues. The Ninth Circuit also rejected plaintiff's assertion that her supervisor's gruff, abrupt, and intimidating conduct constituted outrageous conduct required for an intentional infliction of emotional distress claim.

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In the case of ***Wang v. Chinese Daily News, Inc.*** (9th Cir. 2013), ___ F.3d ___, 2013 W.L. 4712728, the Ninth Circuit reversed the district court's granting of class certification under Federal Rule 23(b)(2) on claims by a purported class of former and future CDN employees who claimed they were made to work overtime, denied overtime compensation and meal and rest breaks, and assorted related claims. Though this case proceeded to trial with a judgment for the purported class, the Ninth Circuit reversed the trial court's granting of certification, finding that the trial court had abused its discretion. The trial court had, in the view of the Ninth Circuit, unduly focused on the fact that the plaintiffs were challenging a uniform employer policy with regard to classification of reporters and account executives as exempt. The Ninth Circuit said that the district court had essentially created a presumption that class certification is proper when an employer's internal exemption policies are applied uniformly to the employees. The Ninth Circuit said that a district court abused its discretion in relying on that uniform policy to the exclusion of other factors relevant to the predominance inquiry inherent in the class certification process.

State

In the case of ***McCoy v. Pacific Maritime Association*** (2013) 216 Cal. App. 4th 283, the Second District affirmed the trial court's granting of summary adjudication to defendant on all claims except retaliation under FEHA and, in particular, on plaintiff's sexual harassment claim. Plaintiff McCoy had been working as a marine clerk at the ports. Thereafter, after receiving training, she became a vessel planner. She alleged that one vessel planner who trained her harassed her. Specifically, she alleged that on between five to nine occasions he would comment on the buttocks of other female employees, use racial slurs, and also make crude gestures toward a woman when the woman's back was turned, but in front of plaintiff. The Second District affirmed the trial court's decision that this conduct, in light of the totality of the circumstances, did not constitute severe and pervasive conduct sufficient for a hostile work environment. The *McCoy* court noted that when sexual conduct involves or is aimed at persons other than the plaintiff, that conduct is considered less offensive and severe than conduct that is directed at the plaintiff directly. The *McCoy* court stated that although crude and offensive, the alleged comments over the four-month period the plaintiff worked in the vessel planner's office were not so severe and pervasive as to alter the conditions of her employment.

In ***Faulkinbury v. Boyd & Associates*** (2013) 216 Cal.App.4th 220, the Fourth District reversed the trial court's order denying class certification after having been asked by the California Supreme Court to review its prior affirmance of that decision under the California Supreme Court's decision in *Brinker Restaurant Corp. v. Superior Court*. The plaintiffs in that case sought to represent and certify a class of about 4,000 current and former employees of Boyd & Associates that provide security guard services throughout Southern California. The claims included claims for unpaid overtime and meal and rest breaks. The Fourth District found in reconsidering the case that the class was ascertainable and that common questions predominated, and that any differences in damages and individual questions as to whether the nature of employees' work prevented employees from being relieved of all duty in order to take a meal or rest break, did not preclude certification.

In the case of ***Heyen v. Safeway, Inc.*** (2013) 216 Cal.App.4th 795, the Second District affirmed the trial court's judgment in the employee's favor on a claim for unpaid overtime based on her alleged misclassification as an exempt employee. In that case, the plaintiff, who was a former assistant manager for Safeway, alleged that Safeway had misclassified her as exempt. She claimed that the demands of her job required that she work much more than 40 hours a week and that she was required to do considerable nonexempt work, including bagging groceries. Safeway argued that the trial court should have recognized that a managerial employee can simultaneously do exempt and nonexempt work. The Second District rejected that assertion, finding that the Labor Code does not recognize hybrid activities; i.e., activities that have both exempt and nonexempt aspects. The *Heyen* court further rejected Safeway's assertion that the "realistic expectations" rule supported its assertion that Heyen was an exempt employee. The Court of Appeal found considerable evidence that the employer had a practice of requiring Heyen to do bookkeeping work and she was forced to work at checkout due to the store's operating ratios. Therefore, plaintiff's practice of doing significant amounts of nonexempt work did not deviate from Safeway's reasonable expectations.

In ***Carter v. Entercom Sacramento, LLC*** (2013) 219 Cal. App. 4th 337, the Third District rejected the plaintiff's claims for indemnity under California Labor Code section 2802. Plaintiff sought indemnity for attorneys' fees and costs he incurred in defending a lawsuit brought by a woman who died from drinking too much water in an ill-conceived radio contest the plaintiff conducted as part of his duties as an employee of the company that owned the radio station. In *Carter*, the plaintiff had rejected an offer by the employer's insurer to retain counsel on his behalf. He, instead, insisted that he be allowed to keep, at the insurer's cost, the attorney he personally selected. The Third District rejected the plaintiff's assertions that he was entitled to whatever counsel he wanted, as section 2802 only requires indemnity for "necessary" expenditures. Plaintiff failed to produce sufficient evidence to establish that he was entitled to indemnity for an attorney he demanded, in view of the insurer's unconditional offer to defend him with counsel it selected.

In ***Alamo v. Practice Management Information Corp.*** (2013) 219 Cal. App. 4th 466, the Second District reversed a judgment in plaintiff's favor on claims for pregnancy discrimination and retaliation, in violation of FEHA. The trial court had authorized a jury instruction that provided that Alamo only had to prove her pregnancy-related leave was a "motivating reason" for her discharge. The Second District stated that in view of the California Supreme Court's decision in *Harris v. City of Santa Monica* (2013) 56 Cal.4th 203, the trial court should have used a jury instruction providing that the standard of causation in a FEHA discrimination or retaliation claim is not a motivating reason, but rather "a substantial motivating reason." For that reason, the Court of Appeal reversed and remanded the case to the trial court.

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Construction Law Newsletter

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Developers Beware

SB800 Not Exclusive Remedy for Construction Defect Damages

By Michael D. Worthing, Esq. and Kyle W. Holmes, Esq.

Adding to the few published opinions interpreting the California Right to Repair Act (Civil Code § 895 et seq., also known as SB 800), the Fourth District Court of Appeal in *Liberty Mutual Insurance Company v. Brookfield Crystal Cove LLC*, (2013) 219 Cal.App.4th 98 held that the Act is not the exclusive remedy available to homeowners who suffer actual damages from construction defects, and that common law rights and remedies remain available against a developer.

In *Brookfield*, a residence was damaged when a pipe in the sprinkler system burst. Repairs to the building necessitated that the homeowner be relocated while work was being done. Homeowner's insurer, Liberty Mutual, paid for homeowner's relocation expenses and sued the builder, Brookfield, for its costs in subrogation. The trial court ruled that the subrogee's claims were time barred under the Right to Repair Act.

The Appellate Court reversed. The Court reasoned that the Right to Repair Act was passed in response to *Aas v Superior Court*, (2000) 24 Cal.4th 627 and was intended to supplement the remedies available to potential plaintiffs. In *Aas*, the California Supreme Court ruled that construction defects which had not caused actual damage to other components of the structure were not actionable in tort. Rather than wait for defective conditions in residential buildings to cause actual damage, the California Legislature provided an alternative and, according to the Fourth District, supplemental remedy through the Right to Repair Act.

The Right to Repair Act permits a plaintiff to recover for allegedly defective conditions based only on a showing of failure to meet specified standards as opposed to actual damage. Since its enactment, it was widely believed that the language of the Act made it the exclusive remedy for construction defect claims for homes sold after January 1, 2003. Indeed, the trial court in *Brookfield* reached this conclusion, and held that Liberty Mutual's subrogation action was untimely. The Fourth District reversed, holding that the Act did not apply to Liberty's cause of action because as a subrogee it had suffered actual damages, and was therefore entitled to bring common law claims outside the applicable time limit under the Act.

A petition for review of *Brookfield* is pending before the California Supreme Court, but if the decision stands, it may be problematic

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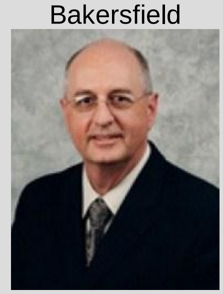

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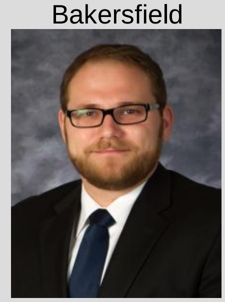

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because it creates uncertainty for developers, general contractors, and subcontractors, who now cannot rely on the statutes of limitation provided in the Act. Rather these businesses must now guess as to which statutes of limitation to apply to the variety of construction defect claims, parsing the law between the Right to Repair Act and common law remedies. This uncertainty is likely to affect development decisions in the future as businesses and insurers assess the likelihood that companies face litigation for past work which would otherwise have been time barred under the Act.

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Business Law Newsletter

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Business Entities for Startups

By Samire K. Elhouty, Esq.

Starting a new business can be an exciting time for new entrepreneurs. Coming up with a new idea, business model, and business name can be challenging, but it could be the beginning of a financially rewarding and deeply satisfying experience. Once founders have moved beyond the ideation stage in creating a new business, the next step is to create a formal business entity. Choosing the right business entity is a major stepping stone in forming a successful business. There are five traditional business entity types that are used to organize a business and one new one.

1. Sole Proprietorship

A Sole Proprietorship is a form of business organization where a single individual owns the business directly without the use of an actual business entity such as a corporation or an LLC.

Pros: The Sole Proprietorship is the simplest type of business organization. Most of the formalities required to set up a corporation are avoided with a Sole Proprietorship. As a result, there are generally no legal fees or filing fees (other than fees associated with filing for a fictitious business name in the county where the proprietorship's principal place of business is located). A Sole Proprietorship is the easiest business organization to maintain, since there are less corporate formalities required, such as keeping corporate minutes or preparing bylaws and there is no alternate minimum tax.

Cons: Since there is no business entity through which the business is operating, everything is in the sole proprietors own name. As a result, the sole proprietor faces unlimited personal liability (that is, both financial and legal liabilities of the business). Unlike the unlimited continuity of a corporation, the personal nature of a Sole Proprietorship also means that the business dies with the proprietor. For those looking to expand their business, it is important to note that Sole Proprietorships cannot issue shares or membership interests. Any ownership interest that is granted to another individual could unintentionally lead to the creation of a general partnership.

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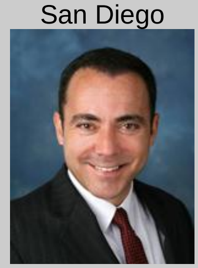

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2. General Partnership

A General Partnership is a business entity made up of two or more people that can be formed explicitly with a partnership agreement or by implicit agreement of the partners.

Pros: Like a Sole Proprietorship, there are no incorporation or filing fees needed to create a General Partnership. Usually, the only formation costs are legal fees for preparation of a partnership agreement. Although a partnership agreement is usually recommended in order to clarify the terms of the relationship between the partners, it is not mandatory. General Partnerships are also cheap and easy to operate, since there are no required shareholder or board meetings.

Cons: A General Partnership, like a Sole Proprietorship, provides no shield against personal liability. In fact, a General Partnership is a more risky proposition than going it alone in that each partner is liable for the other partners' actions. For example, if Partner A takes out a substantial line of credit for the partnership without Partner B's knowledge or authorization, and Partner A defaults, Partner B may be liable for Partner A's debt. Similarly, if Partner A commits a tort while on partnership business (e.g., causes a car accident on the way to a business event, sexually harasses an employee, etc.), the personal assets of Partner B could be used to satisfy a judgment against the partnership. Even with a superbly drafted partnership agreement, and even if each partner is carefully vetted, a founder takes a massive risk by choosing to do business as a General Partnership.

3. Limited Liability Company (LLC)
A Limited Liability Company is a hybrid business entity which combines features of both a corporation and a partnership. Although LLCs are considered to be unincorporated, Articles of Organization must still be filed with the California Secretary of State.

Pros: The main benefit of using an LLC, is that it combines the limited liability protection of a corporation and the favorable pass through tax treatment of a partnership. Unlike a Sole Proprietorship or General Partnership, the LLC generally limits personal liability and obligations of LLC members. Additionally, favorable pass through tax treatment means that the LLC avoids the double taxation faced by C Corporations. Instead, LLC members are taxed directly rather than having the business pay taxes first, then having members pay personal taxes on distributions.

Cons: Combining the favorable aspects of corporations and partnerships does, however, have its drawbacks. The complexity involved in combining business entities the way an LLC does may lead to increased legal fees concerning formation and yearly maintenance. Unlike Sole Proprietorships and General Partnerships, there are mandatory state filing fees and a minimum annual franchise tax for LLCs. Although ownership interest in an LLC is

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freely transferable (in the form of "membership interests"), professional investors typically prefer shares of a C Corporation over LLC membership interests.

4. C Corporation

A C Corporation is by far the most common form of business entity in America. It is a limited liability business entity that is owned by shareholders, governed by a Board of Directors, and managed on a day-to-day basis by a CEO or President and other appointed officers.

Pros: The C Corporation is the most familiar form of business entity to lawyers and business professionals, which generally makes it easier and cheaper to resolve legal issues that may arise. Being the most common and familiar form of business entity also means it is the preferred entity by professional investors. There are no restrictions on the types of shareholders that can be a part of a C Corporation and more than one class of stock is permissible (e.g., preferred and common stock). Besides being the preferred entity for investors, the C Corporation also provides limited liability protection to its' shareholders.

Cons: The main downside to a C Corporation is the time and expense involved in forming and maintaining this type of entity. Corporate formalities must be maintained or the business risks losing its liability shield. There are also legal fees associated with formation and yearly maintenance in addition to state filing fees and the minimum annual franchise tax. However, the most regularly cited and complained about feature of the C Corporation is the double taxation generally incurred. Double taxation occurs when the corporation pays corporate taxes on income earned, then, when shareholders are paid through a dividend, each shareholder must pay a dividend tax. As a result, the corporation's earnings, technically, are taxed twice- once at the corporate level and once at the personal shareholder level.

5. S Corporation

An S Corporation is organized in the same way as a C Corporation, but with more favorable tax treatment and greater restrictions on who can be a shareholder.

Pros: Many of the favorable aspects of a C Corporation also apply to S Corporations, e.g., limited personal liability for shareholders and formal management structure. In addition to sharing the same familiar structure as a C Corporation, S Corporations are "pass through entities." In other words, each shareholder pays taxes, directly, on the income of the corporation instead of taxes being paid by both the corporation and the shareholders as is the case with C Corporations.

Cons: S Corporations are just as costly to form and maintain as C Corporations, but they also have shareholder restrictions that C Corporations do not have. For example, an S Corporation may only have 100 shareholders, shareholders must generally be people (no corporate investors), and each shareholder must be a U.S. citizen. For small business owners, these restrictions usually aren't an issue, but they can be a problem for companies seeking professional investors for capital raises.

6. B Corporation

The B Corporation is one of the newest types of businesses authorized in California. B Corporations are required to operate for the general public benefit, which is defined under California Corporations Code §14601(c) as "a material positive impact on society and the environment, taken as a whole, as assessed against a third-party standard..." The B Corporation is formed and organized just like a C Corporation, but with the added requirements of electing the B Corporation status, passing a third party audit (regarding the impact on society and the environment that the business has), and explicitly stating in the articles of incorporation, "This corporation is a benefit corporation."

Pros: In addition to providing limited liability protection similar to that of a C Corporation, the B Corporation is meant to facilitate social entrepreneurship that ordinarily would not be possible with the business entities previously mentioned. In classical corporate structures, the board of directors and the officers of a company are tasked with maximizing shareholder value. All other activities are secondary. A board or a CEO who diverts corporate funds to charitable or socially conscious activities can face liability if there is no underlying business reason for doing so. The B Corporation eliminates this problem by explicitly allowing board members and corporate officers to run the company with other factors in mind besides the profit motive. Choosing the B Corporation shows consumers and employees that the board and officers of the company are serious about social entrepreneurship.

Cons: Beyond receiving a certificate upon passing a third party audit, there is not much else to incentivize entrepreneurs to use this particular business entity. Choosing this type of corporation requires the time, expense, and frustration of passing a yearly third party audit, the results of which must be distributed to all shareholders. However, there are no tax incentives or reduced filing fees that one would have expected from choosing this type of business entity. Additionally, as a B Corporation, the directors and officers are required to consider the general public benefit and any specific public benefit that may be listed in the articles of incorporation. A benefit enforcement proceeding can be initiated against the corporation, its directors, and/or its officers for failure to pursue the general and/or a specific public benefit. In such proceedings, the corporation would not be liable for monetary damages beyond reimbursing the plaintiff for the reasonable expenses in bringing the suit.

This list is not an exhaustive list of all possible business entities. Entities such as Flexible Purpose Corporations, Limited Partnerships, Real Estate Investment Trusts, and so on, can all be useful choices depending on the specifics of the new business and the goals of the founders. Although a business entity can be converted into another type of entity after formation, the process can end up being prohibitively expensive. The best practice would be to discuss it with an attorney and a CPA before making a final decision. Once the business has been formally organized, the real work of building and expanding the company can begin.

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