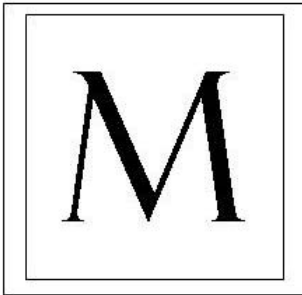


# “BUSINESS LAWYERS SERVING BUSINESS”



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## **In this Issue:**

**Welcome**  
**Preserving the Corporation and Protecting Shareholders**  
**Wills and Estate Planning**  
**Section 32 High Cost Mortgage Loans**  
**Contact Us**

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### **Welcome**

Dear Friends,

In an effort to continue to address issues that are facing you, we are pleased to present our latest McCarrey Law Group Newsletter. With the continuing uncertainty in the credit markets, volatility in the real estate markets and concerns about inflation, we know that each of you are facing new challenges in conducting your business. With difficult times, however, come new opportunities and we are excited to see the new ventures and businesses that many of you are creating.

This edition of our newsletter is unique in that it addresses specific questions raised by our clients. In this issue, we address how to preserve the integrity of the

corporation and how to protect the shareholders from alter ego claims , some very fundamental issues related to wills and estate planning and Section 32 of Regulation Z with respect to high cost mortgage loans.

We remain appreciative of the opportunity that we have to serve you. As your lawyers, we are mindful of the trust that is involved in the lawyer-client relationship and look forward to our continuing association with you. We also appreciate your referrals of your friends and associates and will do everything we can to see that they are properly represented.

The mission of the McCarrey Law Group is to provide sound legal advice tempered by the realities of the business world. Our lawyers operate in the real world and understand the challenges that business faces. The purpose of "Business Lawyers Serving Business" is to highlight both issues and solutions to problems facing you and the rest of our diverse group of clients.

If there are issues that you would like to see addressed in our Newsletter, please contact us. We prize our relationship with you and look forward to continuing our association.

## **THE MCCARREY LAW GROUP**

### **Preserving the Corporation and Protecting Shareholders**

Although an individual can never shield himself from his own tortious or wanton acts through the use of a corporation, a properly formed corporation may be used to limit much of the liability associated with the conduct of his business. A corporation is intended to protect its shareholders from the effect of a corporate breach of contract or the wrongful actions of its employees or agents.

Under certain circumstances, however, the law will look through the formality of the corporate structure and attach individual liability to shareholders. This doctrine, sometimes referred to as "alter ego" or "piercing the corporate veil," permits a court to disregard the corporate structure and to treat shareholders as if there were no corporation. Equitable in nature, the doctrine of alter ego is applied by courts in California when (1) there is such a unity of interest and ownership between the corporation and its shareholders that the separate personalities of each no longer exist and (2) an inequitable result would be reached if the acts complained of were to be treated as those of the corporation alone.

Courts have detailed which factual situations will warrant the piercing of the corporate veil and which factors, when present, are most heavily weighted towards invoking an alter ego remedy. Factually, courts who invoke the alter ego doctrine focus on whether (1) the corporation was properly capitalized at the time of formation, (2) corporate formalities have been maintained and (3) the business affairs and activities of the corporation are kept separate from those of its shareholders.

Often, the corporate veil is pierced when the corporation was under capitalized. Generally, to properly capitalize a new corporation, the shareholders must implement a capitalization plan that will permit the corporation to operate for the period of time beginning with its formation to the time that it is able to sustain its activities. Courts have not prescribed a formula that details the correct ratio of debt to equity for a

new corporation, but the emphasis should be on having as much equity as possible and as little debt as is feasible.

The concept of corporate formalities is broad. For instance, the holding of required meetings and the issuing of stock are two of the more common corporate formalities that must be observed. Failure to keep minutes of required corporate meetings or to actually issue stock certificates to shareholders may be enough for a court to pierce the veil of corporate separateness.

Courts charged with piercing the corporate veil will look closely at whether or not transactions between shareholders and the corporation are done on an "arms length" basis. In essence, the assets of the corporation and the shareholders should not be commingled and all transactions between the corporation and its shareholders should be properly documented. In addition, the California Corporations Code deals specifically with conflict of interest transactions and care must be taken to avoid shareholders acting in their personal best interests to the detriment of those of the corporation.

While it is impossible to delineate all of the possible ways that the existence of the corporation may be disregarded, the following guidelines are intended to help you preserve the protections that you thought you were obtaining when you incorporated your business:

1. **Observe corporate formalities by holding the meetings required by the corporations bylaws.** At a minimum, these meetings will include required shareholder and director meetings as well as meetings required when significant corporate action is being undertaken.
2. **Issue stock certificates to the shareholders.** In the process, insure that the consideration to be received by the corporation in return for the stock is in fact received.
3. **When creating a corporation, make adequate capital provisions.** Make a reasonable plan and provide for the foreseeable obligations of the corporation from the time of its creation to the time of its economic viability.
4. **Make sure that all paid in capital committed to the corporation is received by the company.** In some instances, promissory notes have been used to capitalize the corporation, but no effort is ever made to collect the notes when the need arises.
5. **Conduct all transactions between the corporation and its shareholders on an arms length basis.** Clearly document all transactions between the corporation and any of its shareholders. For instance, a loan from a corporation to a shareholder should be evidenced by a promissory note.
6. **File all appropriate tax returns.** The failure to file tax returns may result in the state dissolving your corporation.

The McCarrey Law Group has an audit program that it implements when asked to insure that corporate formalities are met. If you are interested, please call.

## **Wills and Estates Planning**

We have found over the past several months that many of our clients, including business owners have avoided taking the steps required to create a strategy for dealing with their estate or their business succession upon their demise. In addition,

many have not taken the most basic steps of creating a will that among other things names a guardian for their minor children, executing a durable power of attorney or crafting a mental health directive for use in the case of incapacitation. While these items can be distasteful and cause each of us to face our own mortality, the failure to address these issues can cause unnecessary stress and turmoil to loved ones, result in the imposition of significant tax liability that otherwise might legally have been avoided and the ruining of a family business.

The following steps, in part suggested by Merrill Lynch, will help you tailor a program that is best for your family and the protection of the wealth that you have created during your lifetime:

1. **Talk with your family about your situation and your concerns.** It is self evident that the best way to plan for the future of your family is to talk together about goals and the resources required to meet those goals. Unclear wills or surprises can create unlimited levels of problems for executors and in the process create a significant expense and sometimes heartache that otherwise could have been avoided.
2. **Prepare a will and nominate an executor.** Without a will, your assets will be distributed in the manner provided by the law. This may not be the best for your family and may result in anomalous situations where your loved ones with the greatest needs will be allocated the fewest of your assets. An executor will know your wishes and desires and will be in the best position to carry out your desires. Life situations change and as when they do, thought should be given to the need to change the provisions of wills and estate plans to take into account these life changes.
3. **Transfer assets to your family while you are alive.** To the extent that you have assets that exceed your foreseeable needs, gifts and awards while you are alive permit you to take advantage of annual and lifetime gift exemptions.
4. **If you or your family owns a business, plan for succession.** A recent Merrill Lynch survey showed that less than half of the family owned businesses had a succession plan and more than half did not have an updated business valuation. Properly planning for the succession of your business can result in the business going forward after your demise with a minimal amount of delay or cost.
5. **Take advantage of trusts and life insurance.** Many costs and delays in the passing of wealth can be minimized through the proper use of trust vehicles and many expenses can be paid through the use of inexpensive life insurance products.
6. **Use professionals to guide you through this process.** A professional can guide through a potentially process and will provide the best opportunity for you wishes to be accommodated upon your death.

The McCarrey Law Group has prepared checklists for creating wills, estate planning, durable powers of attorney and advance health directives. If you would like access to any of these planning devices, please contact us and we will provide them to you free of charge.

## **Section 32 High Cost Mortgage Loans**

The Home Ownership and Equity Protection Act of 1994 ("HOEPA") created the model for identifying a "high cost mortgage" or a mortgage that has interest rates or costs that exceed stated levels. The whole concept of a high cost mortgage can be elusive since the definition for these mortgages is determined by looking to a series of laws. However, a mortgage broker must understand the intricacies of the law or face severe penalties for its violation.

The penalties for failing to comply with the law are substantial and among other things, include requiring the originator to refund all closing costs and interest to the borrower—effectively making the loan cost free to the borrower. In addition, any institution that has funded a high cost mortgage will look to the broker to remedy all violations of Section 32 of Regulation Z of the federal Truth in Lending Act ("TILA"), which is the implementing legislation for federal high cost mortgages. Like many states, California has a high cost mortgage statute that is more stringent than the federal law in defining the parameters of a high cost mortgage and the provisions of California Financial Code § 4970 must be considered before a consumer credit transaction is closed.

HOEPA instituted federal high cost loans and the Federal Reserve Board, which interprets TILA promulgated 12 CFR § 226.32, commonly known as Section 32. Section 32 only applies to closed-end consumer loans made on a borrower's primary residence. There are several characteristics that bring consumer loans within the Section 32 ambit. A consumer mortgage loan will be a Section 32 loan if (1) the points and fees exceed eight percent (8%) of the loan amount and/or (2) the annual percentage rate is more than eight percent (8%) higher than the comparable Treasury bill in the case of a first lien, or more than ten percent (10%) higher than the comparable Treasury bill for a junior lien. In California, a mortgage becomes a high cost mortgage if the points and fees exceed six percent (6%) and/or the mortgage rate exceeds the comparable Treasury bill by more than eight percent (8%).

While high cost loans have restrictions and additional disclosure requirements, they normally are otherwise treated as regular mortgages. Generally, these loans cannot have:

- Balloon payments or termination provisions that contemplate a period of less than five years;
- Prepayment penalties without taking into account the borrower's ability to pay and unless the borrower's back-end debt ratio is fifty percent (50%) or less;
- Negative amortization;
- Due on demand provisions; or,
- More than two months of required advance payments to the lender.

In addition to these restrictions, the lender must give the following additional disclosures at least three (3) days before the loan closes:

- Actual annual percentage rate;
- The borrower's regular periodic payment and balloon payment, if any;
- A statement that the monthly payment may increase, in the case of a variable rate loan and the maximum amount of the monthly payment in those cases; and,

- The total that the borrower will borrow if the loan is a refinance.

In addition, during this time period, a verbatim disclosure prescribed by statute must be given to the borrower indicating that the borrower is not required to complete the transaction simply because they executed the disclosure and that the borrower could lose his home if he does not repay the mortgage.

TILA provides that home equity lines of credit ("HELOCS") are exempt from Section 32, provided they are not used simply an attempt to evade its provisions. We are not aware of any meaningful interpretation of what constitutes an attempt to evade the provisions of Section 32. If there is an area that is ripe for litigation it would be with respect to interest only HELOCS that have balloon payments.

In many instances mortgage brokers are making loans that have high interest rates and/or high fees and points that are not consumer credit transactions. 15 USC § 1602(h) defines consumer credit transactions as those where the funds "are primarily for personal, family or household purposes." While there is not a significant body of litigation which further illuminates the nature of personal, family or household purposes, generally, courts have concluded that debt incurred for a business venture or with a profit motive does not fall into the category of debt incurred for personal, family, or household purposes. If a high interest rate or high fee non-consumer credit loan which is secured by the principal residence of the borrower is being made, we would suggest that a certificate be obtained from the borrower indicating in clear and unequivocal language that the loan proceeds will not be used for personal, family or household purposes.

## **Contact Us**

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The McCarrey Law Group is a boutique firm that provides legal services to real estate professionals, financial institutions, entrepreneurs and businesses operating among the NAFTA countries. We are worldwide in our view, but never forget that our business is our clients. We desire to provide you with the best legal service possible and hope that you will find "Business Lawyers Serving Business" helpful and informative.

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