

# THE HAGAN LAW FIRM

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### START-UP CALIFORNIA CORPORATION PRIMER

#### FOR PROFIT CORPORATIONS

by

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This Primer is intended to help new FOR PROFIT corporations start-up on solid footing by creating a check list of items that require attention and completion, explaining those items more fully to provide the founder(s) with a basic understanding of those mundane but important items, and to red flag areas which may require the assistance of counsel. We have included telephone numbers, addresses, and website locations to assist you.

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## **1. Basic Information Concerning Your California Corporation**

**A. Where Incorporation Takes Place.** Incorporation takes place through the **Office of the Secretary of State** for the State of California (and **not** the Department of Corporations). There are several offices located throughout the state, however, the main office is located at:

**1500 11<sup>th</sup> Street**

**Sacramento, California 95814**

**(916) 653-6814**

**[www.ss.ca.gov](http://www.ss.ca.gov)**

If you wish to file over the counter for same day service, there is an office of the Secretary of State located at:

**455 Golden Gate Avenue, Suite 14500**

**San Francisco, CA 94102-7007**

**(415) 557-8000**

This office will not accept mail, but will accept Articles of Incorporation filed over the counter and will provide limited over-the-counter service for certain processing requests.

**B. Initial Filing Fees.** As of November 24, 2000, the initial Filing Fee for incorporation of a for-profit corporation is **\$100**. If you file over the counter, an additional \$15 filing fee will be assessed for special handling.

## **2. Shareholders, Federal and State Regulation of Securities Transactions.**

**Every for profit corporation must have at least one shareholder.**

**The sale of your corporate stock IS the sale of a security under state and federal securities laws. There are strict and detailed prohibitions concerning the sale of securities.**

Both federal and California law regulate transactions in corporate securities. These regulations affect both new issuances of securities and transfers of previously issued securities. These legal requirements are quite complex, and a detailed discussion of them is beyond the scope of this memorandum. Different factual situations give rise to different legal consequences, and it is therefore imperative that legal

counsel be consulted before any proposed issuance or transfer of securities.

State Securities Transactions are regulated by the **Department of Corporations** located at:

**1515 K Street, Suite 200**

**Sacramento, CA 95814-4052**

**(916) 445-7205**

[www.corp.ca.gov](http://www.corp.ca.gov)

Federal Securities Transactions are regulated by the United States Securities And Exchange Commission located at:

**450 Fifth Street N.W.**

**Washington, D.C. 20549-0019**

**(202) 942-7040**

[www.sec.gov](http://www.sec.gov)

### **3. Board of Directors and Regulation of Corporate Affairs**

Unless the corporation has made a so-called "close corporation" election and the shareholders have implemented the election with a shareholders agreement, the final authority for managing the affairs of the corporation rests with the Board of Directors who are charged by law with responsibility for controlling the business and affairs of the corporation. The Board of Directors should pass on all major items of corporate policy, including particularly the election of officers, delegations of and limitations on authority of officers and others, issuance of stock and other securities, and commitment of funds through budgets or otherwise. The officers of the corporation make day-to-day decisions in conformance with policies adopted by the Board. The Board can take action either at a meeting duly called at which a quorum of the directors is present or by unanimous written consent without a meeting. Directors meetings should generally be held at least every few months.

Shareholder meetings will generally be held at the same time each year, although special meetings may be called to consider important matters such as a proposed merger.

The Bylaws of the corporation set forth detailed provisions regulating the responsibilities of the shareholders, directors and officers of the corporation, the manner of calling and holding meetings of the shareholders and directors of the corporation, miscellaneous requirements concerning such things as reports to shareholders, maintenance of corporate records, execution of contracts, and other matters. The Bylaws may also contain restrictions on transfer of shares, such as a requirement that the corporation or shareholders have the right to purchase any shares before they are sold to an outsider. Within certain restrictions, the Bylaws can be amended by the Board or the shareholders. In both cases majority approval is sufficient unless the Bylaws or the Corporations Code provide otherwise. No filing with the Secretary of State is necessary.

#### **4. Preserving Limited Liability**

One of the attributes of a corporation is the limited liability of its stockholders. Under normal circumstances, creditors of a corporation cannot reach its stockholders to satisfy corporate debts and obligations except to the extent that the stock has not been fully paid or is expressly assessable. There are circumstances under which courts will disregard the existence of a corporation and hold its stockholders, as the owners of the business, personally liable for the debts and obligations of the corporation. The legal theory is variously referred to as the "alter ego doctrine," "piercing the corporate veil," and "disregarding the corporate entity." This liability has been applied in cases of contract obligations (*e.g.*, promissory notes, warranty claims), tort actions (personal injuries, manufacturer's product liabilities), taxes and other situations.

There are two fundamental requirements which must be satisfied for the alter ego doctrine to apply: (i) that there was such a unity of interest and ownership that the separate personalities of the corporation and the stockholders no longer existed; (ii) that, if the acts are treated as those of the corporation alone, an inequitable result will follow.

The situations in which the alter ego doctrine have been applied have involved one or more of the following factors:

- (a) Domination of the affairs of the corporation by a single stockholder or group of stockholders acting in concert.
- (b) Lack of respect for the corporate existence:
  - (1) Failure to keep proper corporate books separate from personal books, failure to hold directors and stockholders meetings, co-mingling of funds and other assets, etc.
  - (2) Use of corporate assets for personal purposes.
  - (3) Giving others the impression that the real party in interest is the stockholder or that the stockholder will make good the obligations of the corporation, misleading others to believe that they are dealing with

the stockholder rather than the corporation.

(c) Undercapitalization, i.e., failure of the shareholders in good faith to put at the risk of the business unencumbered equity capital reasonably adequate for its prospective liabilities.

Because of the identity of interest requirement, minority stockholders who are not actively engaged in the management of the business have almost no risk of personal liability. The risk is primarily limited to those who not only have a controlling ownership interest, but also actively dominate the affairs of the corporation.

In order to minimize the possibility that the alter ego doctrine will be applied, we recommend adherence to the following procedures:

(1) Always obtain required authorizations from legal authorities, stockholders and directors (acting as a Board in accordance with the Bylaws) for actions taken.

**(2) Hold regular Quarterly Meetings of the Board of Directors. Keep full and proper records for the corporation separate from personal records, including books of account, minutes of directors and stockholders meetings, contracts, applications and authorizations from legal authorities, etc.**

(3) Avoid commingling of corporate funds and other assets with personal funds and assets.

(4) Make it clear in all contacts and corporate documents with others that they are dealing with the corporation, and sign all documents having legal effect in the following manner:

CORPORATE NAME

By: \_\_\_\_\_

(Name and Title of Authorized Officer)

***(Note: Failure to sign corporate documents in a representative capacity may subject the signor to personal liability on corporate debt and obligations.)***

(5) Maintain arm's-length relationships between the corporation and principal stockholders and insure that transactions between the corporation and principal stockholders, directors and officers are fully disclosed to the Board of Directors and, in appropriate cases, to the stockholders and expressly noted in the minutes, that all conflicts of interest are fully disclosed and noted, and that such transactions are authorized by the directors, and, in appropriate cases, the stockholders, by a vote sufficient for the

purpose without counting the vote of the interested persons.

(6) Fund the business with an amount of equity capital which is sufficient in light of the operations of the business.

### **5. Documents and Records; Inspection Rights**

The corporation is required to keep at its principal office a copy of its Bylaws as most recently amended. This copy is to be open to inspection by shareholders at all reasonable times during office hours.

The stock records of the corporation, the books of account and the minutes of proceedings of the shareholders and Board of Directors (and any committees of the Board) of the corporation are required to be open to inspection by any shareholder upon written demand, provided the request is for a purpose reasonably related to his interest as a shareholder. However, these documents are not required to be kept at the principal office, and they are frequently maintained by the corporation's attorneys. In cases where the attorneys maintain the original corporate minute book, it is desirable for the corporation to maintain a duplicate set of minutes for ease of reference.

Each director has the right at any reasonable time to inspect all books, records, documents of every kind, and the physical properties of the corporation, and such inspection may be made in person or by agent or attorney. This right of inspection includes the right to make extracts.

### **6. Federal Tax Identification Number**

A new business must obtain an Employer Identification Number from the Internal Revenue Service. This number is required to be supplied in various tax returns and reports. Application is made on Form SS-4 which should be filed with the Internal Revenue Service on or before the seventh day after the date business begins or in time for the number to be included in any return, statement or other document.

**THE IRS HOTLINE TO OBTAIN AN IMMEDIATE EIN NUMBER IS:**

**(800) 829-4933**

**The Internal Revenue Service regulations and forms can be found at:**

**[U.S. Treasury EIN information page](#)**

### **7. California Employee-Income Tax Withholding**

California has adopted a withholding system for collection of state income taxes which uses or follows federal forms, procedures and requirements as much as possible. The resulting law is administered by the Employment Development Department, which has a number of regional offices throughout the state. Employers must register with the Department within 15 days after becoming subject to the income tax withholding law, the Unemployment Insurance Code, or both. An eight digit number (Employer account number) will be assigned to the employer to be used on all tax return forms. Taxes must be withheld from wages of residents working within or outside of the State of California and from non-residents working within the state. The Federal Form W-4, filed with the employer by the employee specifying the number of personal exemptions of the employee for Federal income tax withholding purposes, is also used in determining the marital status and number of exemptions for California income tax withholding purposes. For detailed information as to the procedures to be followed, and the exact requirements, see the booklet entitled Employer's Tax Guide which may be obtained from the Department at 916-654-7041. California has no system comparable to the federal Social Security tax system.

The Employment Development Department is located at:

**The EDD**

**800 Capitol Mall, MIC 83**

**Sacramento, CA 95814**

**1-888-745-3886**

[www.edd.ca.gov](http://www.edd.ca.gov)

**8. Withholding Federal Employee-Income and Social Security Taxes (F.I.C.A.)**

An employer will ordinarily be required to withhold income and Social Security taxes from taxable wages paid to its employees. The procedures for this withholding may be found in Circular E, *Employers' Tax Guide*, which is distributed by the Internal Revenue Service. Generally, the determination as to whether a person is an employee (as opposed to an "independent contractor") is based upon common law principles. If the employer has the right to control both what services shall be mixed, the IRS can be expected to assert that the person is an employee.

Due to perceived abuses by employers in treating many service providers (from the IRS point of view) as independent contractors, the IRS is auditing more and more employers and imposing deficiency assessments for failure to withhold employee taxes. There is substantial liability for unpaid taxes, plus interest and penalties, if taxes are determined to be due. Therefore, employers using independent contractors should consult with both their lawyer and tax advisor before designating a worker as an independent contractor.

**THE OFFICERS OF THE CORPORATION OR OTHER PERSONS RESPONSIBLE FOR THE WITHHOLDING OF TAXES ON BEHALF OF THE CORPORATION AND FOR PAYING SUCH TAXES TO THE GOVERNMENT MAY BECOME PERSONALLY LIABLE FOR FAILURE TO DO SO.**

### **9. Amortization of Organizational Expenses**

A corporation may amortize its organizational expenses by making an election to do so at the time of filing its first tax return. The election requires a statement to be filed with the return setting forth a description of the expenditures, the date the expenditures were incurred, the month in which the corporation began doing business, and the number of months (not less than 60) over which the expenditures are to be ratably deducted. The period of amortization must begin with the month in which the corporation began doing business.

The services which may be amortized include legal and accounting services incident to incorporation, including expenses of preparation of the first minutes, Bylaws, Articles of Incorporation, and fees paid to the state for incorporation.

Fees paid to the Department of Corporations and the costs incurred in the issue of securities are not includable, and are not otherwise deductible.

### **10. Election of Accounting Period**

A new corporation may elect to be taxed on a calendar year or a fiscal year basis, provided that it regularly computes its income on such basis in keeping its-books. Certain corporations are required to use the calendar year. The initial adoption of a taxable year, where an election is permitted, does not require the consent of the Internal Revenue Service. The period used for filings with the Franchise Tax Board should be identical with that used for federal income tax purposes. The selection of a cash basis or an accrual basis method of accounting is made when the first tax returns are filed. It is a good idea to check with your accountant or other person handling corporate tax matters before choosing a fiscal year.

### **11. Corporate Income Tax Returns**

The first federal income tax return must be filed on or before the fifteenth day of the third month following the close of the taxable year, using Form 1120. Depending upon the amount of tax which the corporation may reasonably be expected to incur, the corporation may be required to make estimated tax payments. Federal estimated tax payments may become due as early as the fifteenth day following the fourth month of the taxable year. **Every corporation is required to file an income tax return regardless of whether it has taxable income or not.**

Corporations incorporated after January 1, 2000, are not subject to the payment of a minimum franchise tax fee of \$800 for the first year in existence. However, the corporation is still required to pay tax on its net income. For all other years, the corporation is subject to an annual minimum tax of \$800 whether or not the corporation is active, inactive, operating at a loss, or filing a short period return for less than 12 months. The California Franchise Tax is imposed in advance for the privilege of operating as a corporate entity in California.

The first corporate return is due on or before the fifteenth day of the third month following the close of the income year, and estimated tax payments may have to be made under procedures similar to the federal procedures. The Franchise Tax Board mails a copy of its guide for filing franchise tax returns by commencing corporations to the first mailing address of the corporation, and this guide describes the filing requirements and sets forth some examples of how the tax is computed on the first two returns.

California has adopted most of the federal provisions for Subchapter S corporations. An S Corporation is a pass through tax entity under IRC Section 1363 and 1366 and allows passive taxation to its shareholders. In order to be a S corporation, the corporation must file a form 100S with the IRS making the election within 75 days of its first day of business, or for any new tax period. However, when converting from a C Corporation status to S Corporation status beware a tax on built in gain under IRC 1374. This tax can be significant.

The Franchise Tax Board may be located at:

**Franchise Tax Board**

**P.O. Box 942857**

**Sacramento, CA 94257-0540**

**(800) 852-5711**

**[www.ftb.ca.gov](http://www.ftb.ca.gov)**

**12. Federal Unemployment Tax**

The corporation will probably be required to pay federal unemployment tax. An employer receives credit to a certain degree for contributions paid by it into state unemployment funds. Details of the procedures and requirements are contained in Circular E, Employer's Tax Guide. Information and assistance with

respect to compliance with the various federal and state tax payment and withholding requirements can be easily obtained from any bank which is an authorized tax depository.

### **13. California Sales and Use Taxes**

With certain specified exceptions, California, like most states, imposes a sales tax on businesses for the privilege of selling tangible personal property at retail. The tax must be collected by the retailer from the consumer insofar as it can be done, but the obligation to pay it is imposed on the retailer. The use tax is imposed upon the storage, use or consumption in the state of tangible personal property which is purchased from a retailer. While the consumer is liable for the use tax, it must be collected by the retailer if the retailer is engaged in business in the state. The use tax is not imposed if the transaction is subject to the sales tax. It will apply primarily where property is purchased or delivered outside of California for eventual use in the state. With certain limited exceptions, the granting of possession of tangible personal property by a lessor to a lessee is considered a continuing sale in California, and the possession of such property by a lessee is considered a continuing purchase for use in California. As a result, the lessor is obligated to collect a sales or use tax at the time following each payment pursuant to the lease.

All persons engaged in California in the business of selling tangible property of the kind subject to the sales or use tax must obtain a Seller's Permit from the State Board of Equalization. Such Permit is usually required even though the business itself sells such property at wholesale, or is a manufacturer. A business which holds a valid Seller's Permit is able to purchase tangible personal property for resale without paying the sales tax, provided it gives the seller a Resale Certificate certifying in good faith that resale will occur.

An officer of the corporation must personally appear at the nearest State Board of Equalization office to apply for a Seller's Permit. In order to get a Permit, the person appearing should be prepared to give certain credit information, as well as other information necessary to enable the Board to estimate the corporation's sales tax liability. The Board has authority to require the posting of collateral to secure the collection of the tax. The corporation may post this collateral in the form of interest-bearing obligations of financial institutions, including certificates of deposit and savings books.

The holder of a Seller's Permit is required to file a combined state, local and district tax return and to pay the taxes collected on at least a quarterly basis.

A separate Permit must be obtained for each place of business, and must be conspicuously displayed at the place for which it is issued.

In addition to the sales and use tax, certain businesses may be subject to excise and other taxes, e.g., sale of alcoholic beverages and cigarettes.

## **The Board of Equalization**

**450 N Street**

**Sacramento, CA 95814**

**(916) 445-6464**

### **[Business Taxes Law Guide](#)**

#### **14. State and Local Business Licenses**

Some trades, occupations and businesses are regulated by the State of California. Generally, these laws require that the licensee meet certain qualifications before engaging in a particular business. Typical examples of this type of licensing are those which regulate professional persons, contractors, or sellers of alcoholic beverages.

Many cities and counties impose additional licensing requirements, primarily for the purpose of raising revenues rather than of regulating the operation of the business. Ordinarily such a license is obtained upon the payment of the prescribed fee to the local authority, but a few cities (including Redwood City and San Francisco) impose a tax on the gross receipts of various businesses, and at least one city, San Francisco, also imposes a tax upon employers measured by the employees payroll. Inquiry should be made to the local authority to determine what requirements are applicable.

All persons and entities engaging in business within the City and County of San Francisco must obtain a current Annual Business Tax Registration certificate from the office of the Tax Collector within 15 days of commencing business (S.F. Muni Code Part III, Sec. 1007). The phone number for more information is (415) 554-4400. The tax collector has a website at <http://www.sfgov.org/tax>.

In addition to licensing requirements, local authorities should be consulted for applicable zoning restrictions and health, fire, building and safety regulations.

#### **15. Workers' Compensation**

With a few exceptions, every California employer is subject to the state workers compensation laws. These laws impose liability upon the employer for accidental injuries suffered by employees in the course of their employment, regardless of the employer's negligence, and provide a schedule of benefits to be paid to the injured employee or his heirs. An employer may be subject to the law even if the employer has only one part-time employee. The employer must either obtain from the Director of Industrial Relations a certificate of consent to self-insure or be insured against workers compensation liability by an authorized insurer. Such insurance may be obtained through the nearest local office of the

State of Compensation Insurance Fund or it may be placed with a licensed workers compensation private carrier. The employer is required to post at this headquarters or one of his places of employment a notice stating the name of the current compensation insurance carrier or that the employer is self-insured. For information regarding workman's compensation requirements contact:

**Division of Labor Standards Enforcement**

**455 Golden Gate Ave., 8th Floor**

**San Francisco, CA 94102**

**(415) 703-5300**

**[DLSE Homepage](#)**

**or**

**Call the California Division of Worker's Compensation**

**(415) 703-5011**

**16. California Property Taxes**

In California every person must pay property taxes on taxable real and personal property owned or possessed on March 1 of each year. Those persons owning taxable personal property having an aggregate cost of \$30,000 or more on such date must file a property statement (signed under penalty of perjury, in the case of a corporation, by an officer of the corporation or an employee or agent designated in writing by the Board of Directors to sign such statements on behalf of the corporation) with the County Assessor no later than such time as the County Assessor may appoint between April 1 and the last Friday in May. Other persons owning real or personal property are required to file a property statement only upon the request of the Assessor. One-half of the real property taxes and all of the personal property taxes on the secured roll are due November 1 and are delinquent December 10 at 5:00 p.m. The second half of the real property taxes are due February 1 and are delinquent on the following April 10 at 5:00 p.m. Property taxes not on the secured roll become due at 12:01 a.m. on the first Monday of March and become delinquent on August 31 at 5:00 p.m.

**17. California Wage and Labor Laws**

California's wage and hour laws are among the toughest in the nation. The Industrial Wage Commission

establishes wage laws and the Division of Labor Standards Enforcement (DSLE) enforces the state wage labor laws. The DSLE is a division of the

**Division of Labor Standards Enforcement**

**455 Golden Gate Ave., 8th Floor**

**San Francisco, CA 94102**

**(415) 703-5300**

[DLSE Homepage](#)

California employers must follow both state and federal wage and hour laws. There are numerous state and federal laws which regulate the working conditions and wages of employees. Briefly described below are some of these laws. The list is not complete.

**Hourly Wages:** For the annual year 2004, California workers who earn minimum wage will be entitled to **\$6.75 an hour**. By contrast, the Federal Minimum wage is \$5.15. When state and federal law differ, employers must comply with the more restrictive requirement, or higher wage. It is illegal for an employer and employee to agree to pay a wage lower than the minimum wage. However, in San Francisco, which has passed its own hourly wage rate, worker's are entitled to a **minimum wage of \$8.50**. San Francisco is now the third city in the Country to set its own higher wage threshold.

**Overtime:** Effective January 1, 2000, California State Assembly Bill 60 (**AB60**) reinstated overtime pay for any work time over eight hours in one day. Specifically, AB60 requires that employees be paid time-and-one-half for all hours worked after eight in one day, and double-time for all hours worked after 12 hours in one day. AB60 also continue the previous law that employees must be paid time-and-one-half for all hours worked over 40 hours in one work week. Employers are not required to pay extra for work on holidays or Sundays unless there is an employer policy statement which promises to do so.

*Note: In the last few years, there have been a number of multimillion dollar overtime wage claim lawsuits. Recently Pac Bell settled for \$35 million, Radio Shack settled for \$30 million, Bank of America settled for \$22 million, Starbucks settled for \$18 million, and Perdue Farms settled for \$10 million. Very often, these lawsuits involve the misclassification of employees as exempt rather than non-exempt. In California, employers must pay non-exempt employees time and a half after eight hours work in one 24 hour period. The determination of whether or not an employee is exempt or not from minimum wage laws must be made on a case by case basis depending on that employee's duties. An employee's title is irrelevant. What matters it the employee's actual job duties.*

**Prevention of Injury:** In 1991 California enacted comprehensive new legislation concerning prevention of illness and injuries resulting from workplace conditions. All California employers are required to develop an illness and injury-prevention program which must: (i) be in writing, (ii) identify the person responsible to ensure compliance with safe practices; (iii) set forth a system for communication to employees about safety matters; (iv) schedule periodic inspections to identify unsafe conditions and work practices; (v) set forth a procedure to investigate occupational injuries and illnesses; (vi) contain procedures to correct unsafe conditions in a timely manner based on the severity of the hazard; (vii) contain training and instruction standards for employees and supervisors; (viii) set forth a record keeping system of periodic inspections, including the identity of persons conducting the inspections, the unsafe conditions noted, and corrective actions taken; and (ix) detail the safety and health training procedures established for each employee. The law provides substantial penalties for non-compliance, including fines and jail terms for supervisory personnel.

**Discrimination:** In addition, the California Fair Employment Practice Act, Title VII of the Federal Civil Rights Act of 1964, and the Federal Age Discrimination in Employment Act of 1967 regulate discrimination in hiring practices, prohibiting discrimination in employment on the basis of such factors as race, religious creed, color, national origin, ancestry, sex, or age. The Americans with Disabilities Act, which became effective in July 1992 and other federal and state laws contain complex provisions concerning employment of persons with various disabilities. The U.S. Equal Employment Opportunity Commission and the California Fair Employment Practice Commission can supply literature and guidelines relating to hiring and advancement of women, minorities and disabled persons.

**Federal Wage Laws:** The Federal Fair Labor Standards Act sets the minimum wage of \$5.15 which applies to practically all employees of businesses engaged in interstate commerce, except for employees in certain categories such as executive, administrative, professional and outside sales personnel. As in the case of withholding taxes, the failure of the person in charge of hiring and firing employees and negotiating wages to see that the required minimum wages are paid may result in such person becoming personally liable. The Federal Department of Labor should be contacted for information.

## **18. Annual Filing with Secretary of State**

Effective January 1, 2003, the California Corporations Code Sections 1502 and 2117 were amended to require that corporations must file an annual statement of information every year. The statement may be obtained online at the Secretary of State's website at [www.ss.ca.gov/business/corp/corp\\_soinfo.htm](http://www.ss.ca.gov/business/corp/corp_soinfo.htm). The filing fee is \$20 with an additional \$5 disclosure fee. A newly organized corporation must file such statement within 90 days after the date of incorporation. Failure to comply may result in a fine of \$250.00. The form of the annual statement will usually be mailed by the Secretary of State to the new corporation; however, the corporation is still required to file the form even if it does not receive one from the Secretary of State. Any time information changes about the officers, agent for service of process or

the principle place of business, the corporation is required to provide the Secretary of State with an update of the new information. If you have questions about the statements, you may call (916) 657-3537.

## **19. Insurance**

As a matter of sound policy, every business should obtain fire and extended peril insurance on all property owned by it or for which it is responsible. Most businesses should also obtain a comprehensive public liability insurance policy insuring them against liabilities imposed by law or otherwise, arising out of the operation of their business and their vehicles and the maintenance of their property. It may be advisable to obtain business interruption insurance, also known as "use and occupancy" insurance. Directors and officers liability insurance may also be desirable. An insurance agent should be consulted.

If the corporation proposes to manufacture products which might be involved in serious personal injuries under normal use, every effort should be made to obtain substantial public liability insurance coverage which would protect the corporation against liabilities for personal injuries sustained in the use of its products, whether such liabilities are imposed on a contract theory of breach of warranty or on a tort theory, such as the California doctrine of manufacturer's absolute liability for damages caused by dangerous products.

## **20. At-Will Employment.**

California's Labor Code Section 2922 states that an employment relationship which has no specified duration is **presumed** to be employment "at-will." This means that, at least in theory, either the employee or employer may terminate the employment relationship at any time, for any reason, or no reason at all.

However, a number of court decisions have created an exception to the Labor Code for an "implied contract." For example, if the employer solicits the employee for "a long-term position" or asks the employee to make a "commitment to the company" for a specified amount of time, an implied contract for a duration may be presumed and thus employment will not be "at-will." In October, 2000, the California Supreme Court handed down a significant decision bolstering the "at-will" employment doctrine against claims of an implied contract. *In Guz v. Bechtel National, Inc.*, 24 Cal. 4<sup>th</sup> 317 (2000), the Court found that where an employer has an express policy of at-will employment stated in the employee handbook, an employee cannot generally claim that there was an "implied contract" only to terminate for "good cause." The Court explained that the mere existence of an employment relationship does not create an expectation that the employment will continue or that it will only end for "good cause."

Although California is an "at-will" employment state, there are exceptions to the at-will doctrine. Both

state and federal law prohibit termination of employees on the basis of certain characteristics such as:

1. Race/color of skin;
2. Religion;
3. National origin/ancestry;
4. Sex;
5. Age (must be 40 and older);
6. Marital status;
7. Disability;
8. Veteran Status;
9. Pregnancy;
10. Sexual orientation;
11. Medical condition; and
12. Union activity.

An employer may not terminate an employee for engaging in certain activity such as:

1. Having wages garnished;
2. Voluntary participation in alcohol or drug rehab program
3. Refusal to authorize disclosure of medical information;
4. Jury Duty;
5. Political Activity;
6. Military Service;
7. Refusing to take a polygraph test;

8. Refusing to sign an employment provision which is against public policy such as a non-compete agreement.
9. Cooperating in investigations undertaken by the EDD;
10. Reporting that other employees are engaged in illegal activities such as kick backs or tax evasion;
11. Refusing to submit to drug testing which violates the employees rights under the California Constitution.
12. Refusing to engage in perjury for the employer.
13. Refusing sexual advances from a supervisor.

All employees should be informed at their job interviews and again at the introduction to the Company that their employment will be "at-will," and such at-will status should be clearly set forth in the Company handbook.

## **21. Polygraph Tests and Lie Detector Tests**

The federal Employee Polygraph Protection Act prohibits most private employers from requesting either a Lie Detector or Polygraph test for pre-employment screening or during the course of employment. Federal, state and local governments are not affected by the law. The Act permits polygraph tests only to be administered in the private sector to certain prospective employees such as security service firms, and of pharmaceutical manufacturers, distributors and dispensers. Violators of the Act can be restrained and assessed a \$10,000 penalty. Employees or job applicants may also bring their own private civil actions against the company. More information about the Act may be found at the U.S. Department of Labor, Employment Standards Administration, Wage and Hour Division, Washington, D.C. 20210.

## **22. Pre-Employment Non-Compete Agreements**

Very often, new employers attempt to insert in a new employee agreement or a company handbook and employment policy manual, a provision that the new employee will not compete against the company for a period of time after termination. Such a provision is prohibited in the State of California and is completely unenforceable against the employee. Other states allow such provisions. However, pursuant to Section 16600 of the California Business & Professions Code, "every contract by which anyone is

restrained from engaging in a lawful profession, trade or business of any kind is to that extent void."

There is a common misconception among employers in California that such non-compete covenants are valid as long as the employee is receiving compensation for the promise not to compete, and the restriction is not overly broad, and is limited in time, place and geography. In many states, this would be a correct assumption. In California, such a presumption may land you in court as a defendant. An invalid covenant not to compete violates Business & Professions Code 17200 which prohibits unfair business practices and unfair competition. This was the finding in the case of *Application Group, Inc., v. Hunter Group, Inc.*, 61 Cal. App. 4<sup>th</sup> 881 (1998) where the court ruled that covenants not to compete contained in employment contracts of non-resident employees are not enforceable. In this case, the Court stated that "California law applies to the hiring of employees to engage in a profession or business in California" no matter where the employee reside. Accordingly, if the business is California based, then it may not impose a non-compete on its employees even if they do not reside in the state.

A business may not make an employee sign a non-compete clause under threat of losing his or her job. In 1996, Aetna Inc., merged with U.S. Healthcare creating a national company. It was the policy of Aetna to obtain a confidentiality agreement from each and every employee in every state. Said agreement also contained a non-compete and non-solicitation clause. Aetna demanded that Anita Walia, an employee working in the state of California sign the confidentiality agreement which would have barred her from working for any health care business in California for a period of six (6) months after her termination. Ms. Walia refused to sign the document and was terminated by Aetna. Ms. Walia sued Aetna and won the sum of \$1.26 million. The court said that Walia's termination constituted a wrongful discharge in violation of public policy. An employer in the state of California simply cannot lawfully make the signing of an employment agreement which contains an unenforceable covenant not to compete, a condition of continued employment. An employer's termination of an employee who refuses to sign such an agreement constitutes a wrongful termination. See *Walia v. Aetna Inc.*, (2001) 93 Cal. App. 4<sup>th</sup> 1213; and *D'Sa v. Playhut* (2000) 85 Cal. App. 4<sup>th</sup> 927.

### **23. Employee Handbook and Policy Manual**

It is critically important for a new business to establish a comprehensive Employee Handbook and Policy Manual before the hiring of new employees. This Manual should include a range of subjects, rules and regulations to which all new employees should be made aware and bound, and which becomes part of the employment package. The Manual should include a discussion of company policies ranging from ADA compliance to non discrimination and prohibitions on sexual harassment. The Manual should also incorporate a statement whereby the employee promises to keep all company secrets confidential. In addition, the Manual should set forth in clear, easy to read detail the vacation, holiday, sick leave and personal day policies of the organization, if any. (Wage law does not require a business to provide any of the aforesaid benefits. However, if a business does, then it must treat and pay all employees equally). These policies must be scrutinized vigorously by the HR manager and legal counsel to make sure that

each and every policy complies with DSLE department standards.

During the hiring process of all new employees, each should be provided with a Manual and the business should obtain a signature from the employee that he/she has read and understood the policies, rules and regulations set forth in the Manual and agrees to be bound thereby.

*The information provided herein is not intended as legal advice and should not be acted upon. If you have additional questions about this subject matter or would like to consult with an attorney, please call Jennifer J. Hagan or James Hagan at The Hagan Law Firm (650) 322-8498.*

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