2004 Holiday Travel & Gift Guide

Blogs and RSS Feeds
PAGE 47

Los Angeles Lawyer

December 2004 / $4

EARN MCLE CREDIT

ETHICAL USE OF PRIVATE INVESTIGATORS
page 31

Making It Personal

Los Angeles lawyers Allen B. Grodsky and B. Alexander Moghaddam explore the liability of directors and officers for corporate torts page 24

PLUS

by Allen B. Grodsky and B. Alexander Moghaddam

Making It Personal

Courts have not yet articulated A SINGLE CLEAR RULE governing the liability of corporate officers or directors in tort

A client calls with a business tort case. A competitor has not only been negligent but has also engaged in fraud, intentionally interfered with prospective business relations, and competed unfairly. These acts have caused several million dollars in damages. There is only one problem: the competitor—a corporation—does not have the money to pay a judgment. However, the competitor's president is personally very wealthy. The client queries whether the president can be sued individually. The answer may be yes, for some claims.

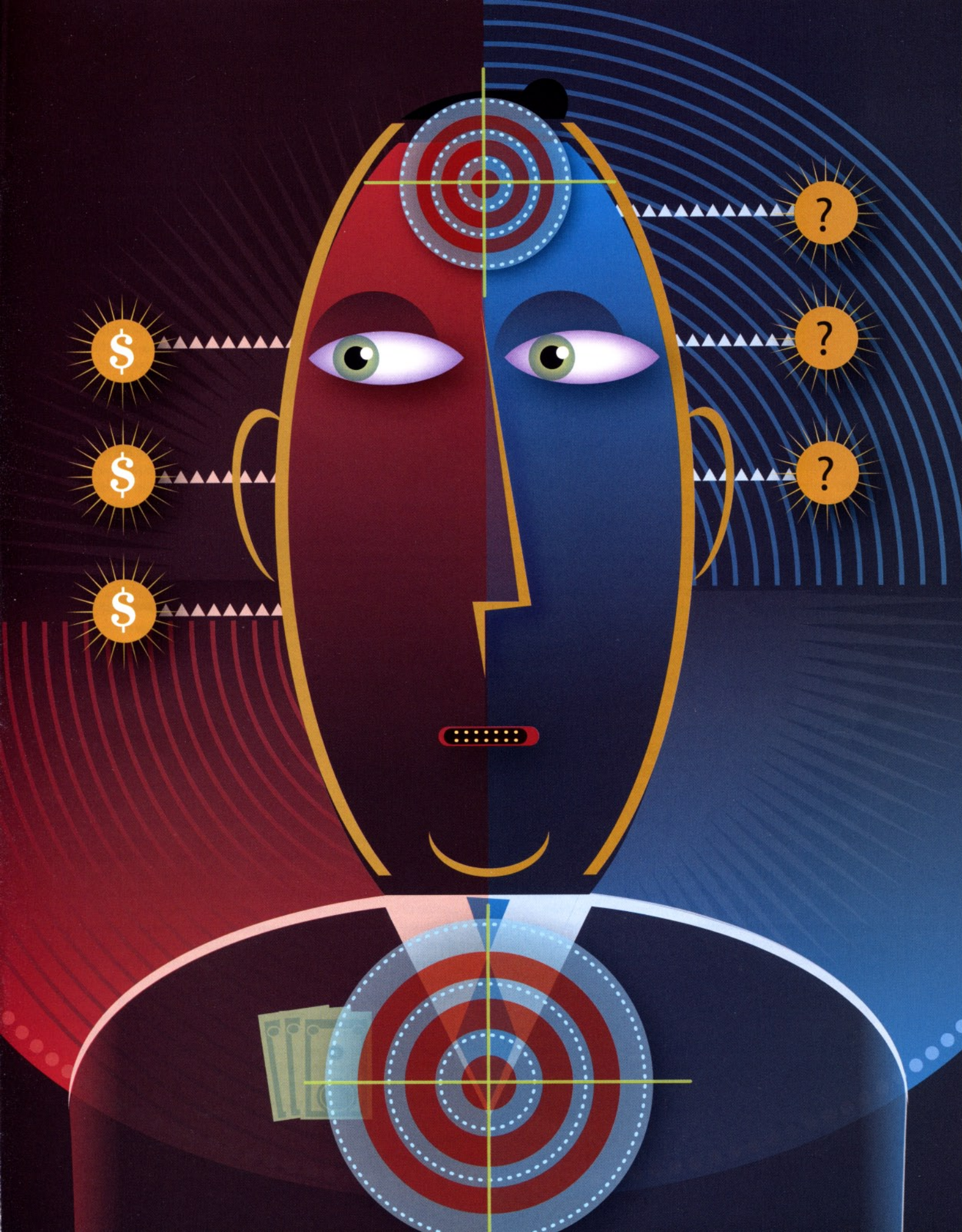
The courts have not yet articulated a single clear rule governing the liability of corporate officers or directors in tort. One broad conclusion, however, may be gleaned from the body of case law that has addressed the issue: Courts are more sympathetic to claims against corporate officers and directors for intentional misconduct than for negligence.

In *Frances T.* v. *Village Green Owners Association*,[1] the California Supreme Court set forth a two-part test to determine whether an officer or director can be held personally liable for a tort. Specifically, a plaintiff must prove that:
1) The director or officer either
- "[S]pecifically authorized, directed or participated in the allegedly tortious conduct"; or
- "[A]lthough they specifically knew or reasonably should have known that some hazardous condition or activity under their control could injure plaintiff, they negligently failed to take or order appropriate action to avoid the harm"; and

2) "[A]n ordinarily prudent person, knowing what the director knew at that time, would not have acted similarly under the circumstances."[2]

Courts apply this test very differently depending on the nature of the tort. For example, it is well established that "[a]ll persons who are shown to have participated in an intentional tort are liable for the full amount of the damages suffered."[3] Courts also have held that "[t]his rule applies to intentional torts committed by shareholders and those acting in their official capacities as officers and directors of a corporation, even though the corporation is also liable."[4] Indeed, courts repeatedly have held corporate officers and directors personally liable for damages caused

Allen B. Grodsky of Grodsky & Olecki LLP in Santa Monica practices business, intellectual property, and entertainment litigation. B. Alexander Moghaddam is a partner at Cogswell, Nakazawa & Chang LLP in Long Beach and Santa Monica, where he practices business, commercial, and maritime litigation.



by their own fraud:

> A corporate officer or agent is personally liable for damages caused by his fraud or deceit, to the person directly injured thereby. As to third persons dealing with a corporation, the directors are merely agents of the corporation, their liability being the same, and if they assist or participate knowingly or recklessly without knowledge, in obtaining property by fraud or deceit, they are liable to an injured person who relies on their representations.[5]

Thus, in *Croeni* v. *Goldstein*,[6] a buyer's officer—the person who allegedly made false representations on behalf of the buyer to induce the sellers to sell their business—was held potentially liable in tort for fraud.[7]

Courts also have found officers and directors personally liable for acts of unfair competition or misappropriation of trade secrets. In *PMC, Inc.* v. *Kadisha*,[8] the majority shareholders of a corporation filed suit for misappropriation of trade secrets against former managers of the corporation who had formed a new company. The plaintiffs also sued individuals who had invested in, and become officers and directors of, the new corporation, for, among other things, misappropriation of trade secrets and unfair competition. The latter group of defendants brought a motion for summary judgment on the ground that they could not be held personally liable for the alleged torts. The trial court granted summary judgment, and the court of appeal reversed, finding that the plaintiffs had stated valid claims against the defendants and raised a triable issue of material fact regarding the defendants' participation in, consent to, or approval of the alleged intentional tortious conduct.[9]

The court of appeal broadly observed that anyone who is found to have "participated in an intentional tort" will be held liable for the full measure of damages incurred.[10] The court cited cases in which corporate officers and directors had been held liable for unfair competition when they had been aware of, or ratified acts of, unfair competition and benefited from the misconduct,[11] or for misappropriation of trade secrets when the corporation not only gained unauthorized access to the secrets but used them on a continuing basis.[12]

The court rejected the defendants' contention that they could not have participated in any trade secret misappropriation violations because the alleged violations predated their investments in the corporation. The court found that "misappropriation is not limited to the initial act of improperly acquiring trade secrets; the use and continuing use of the trade secrets is also misappropriation."[13]

In *Granoll* v. *Yackle*,[14] the court of appeal held that an officer or director can be individually liable for conversion:

> It is well settled by the great weight of authority in this country that the officers of a corporation are personally liable to one whose money or property has been misappropriated or converted by them to the uses of the corporation, although they derived no personal benefit therefrom and acted merely as agents of the corporation.[15]

The court of appeal further explained that "[t]he underlying reason for this rule is that an officer should not be permitted to escape the consequences of his individual wrongdoing by saying that he acted on behalf of a corporation in which he was interested."[16]

Haidinger-Hayes and Negligence

Courts are less likely to find an officer or director personally liable when the tort is negligence. In particular, courts have set a high barrier in determining whether an officer or director owes a duty of care to a third party. Indeed, if there is no duty, there can be no negligence.[17]

The California Supreme Court explains this principle well in *United States Liability Insurance Company* v. *Haidinger-Hayes, Inc.*,[18] a case in which the plaintiff, an insurance company, brought a negligence action against its licensed California insurance agent, Haidinger-Hayes, Inc., and the agent's president, V. M. Haidinger. The negligence alleged by the plaintiff involved the computation of the premium rate charged to one of the plaintiff's insureds. The plaintiff had entered into a general agency contract with the defendant corporation, and under this contract the corporation had the authority to solicit and issue contracts of insurance on behalf of the plaintiff and to determine the premium rates.

The negotiations regarding the Crescent policy were the personal responsibility of the president of Haidinger-Hayes. The president had issued the policy to Crescent on behalf of the corporation and determined the premium rate that was charged. The plaintiff asserted that the defendants were negligent in setting the premium rate charged to Crescent. The trial court found against both defendants on the issue of negligence and awarded $137,606.20 in damages in favor of the plaintiff.

On appeal, the supreme court unanimously reversed the trial court's ruling regarding the president's personal liability to the plaintiff. The court did not dispute the trial court's finding that the president did not exercise reasonable care. However, the court, in essence, found that the president, while certainly owing a duty to the corporation, owed no duty to the plaintiff and thus could not be liable for negligence.

The supreme court initially affirmed the trial court's express finding of the defendant corporation's liability to the plaintiff. But the court observed that "[t]he relationship of defendant V.M. Haidinger to plaintiff is somewhat different. Liability was imposed on him for his active participation in the tortious (negligent) act of his principal which caused pecuniary harm to a third person."[19] The court noted that, based on the facts of that case, it was undisputed that the acts of the corporate officer were done in the course and scope of his employment for and on behalf of the corporation and not as a contracting party.[20]

The court further stated that "[d]irectors or officers of a corporation do not incur personal liability for torts of the corporation merely by reason of their official position, unless they participate in the wrong or authorize or direct that it be done." Corporate officers are not responsible to third persons for "negligence amounting merely to nonfeasance, to a breach of duty owing to a corporation alone; the act must also constitute a breach of duty owed to the third person." The court also observed that liability imposed on agents who actively participate in the tortious acts of their principal have been "mostly restricted to cases involving physical injury, not pecuniary harm, to third persons."[21]

This statement is interesting in that the court framed it in terms of all torts, not just negligence. But courts have shown no reluctance to hold officers or directors personally liable for intentional torts, even if the only damage is pecuniary. Indeed, courts have drawn the distinction between intentional torts and negligence. For example, in *PMC*,[22] the court of appeal distinguished *Haidinger-Hayes* because it "was a negligence action" and "did not involve intentional misconduct."

In *Self-Insurers Security Fund* v. *Esis, Inc.*,[23] the court followed the *Haidinger-Hayes* decision. The plaintiff, Self-Insurers Security Fund, sued, among others, the former vice president of an insolvent self-insured employer, California Canners and Growers (CCG), to recover worker's compensation benefits the plaintiff paid to the company's employees. The plaintiff, which was formed in response to CCG's bankruptcy, alleged, among other things, a cause of action for negligent misrepresentation against the officer, William C. Gruber.

Under the Labor Code, CCG was required to file annual reports with the Department of Labor Relations estimating the company's anticipated worker's compensation liabilities. The department used the reports as a basis for determining the amount of security to be posted by the company. The Labor Code required both the person administering CCG's self-insurance plan and an officer or an autho-

rized employee to sign the reports under oath. Defendant Gruber was the officer who signed the reports in 1981 and 1982, and the company began bankruptcy proceedings in 1983. It was subsequently determined that CCG had underestimated its outstanding worker's compensation liabilities by more than $1 million.

The trial court sustained Gruber's demurrer, and the court of appeal, relying on *Haidinger-Hayes*, affirmed the trial court's decision. The appellate court noted "[the two] traditional limits on a corporate officer's personal liability for negligence" articulated by *Haidinger-Hayes* and later by *Frances T.*: 1) the general resistance to holding a corporate officer personally liable in the absence of physical injury, and 2) the rule that officers are not liable to third parties for breach of duties owed to the corporation alone.[24] Applying these limitations to the facts before it, the appellate court in *Self-Insurers Security Fund* observed that Gruber's conduct, "allegedly resulting in pecuniary harm to CCG employees, was not directed in any fashion toward, or in response to, the employees."[25]

Frances T. and Personal Injury

While acknowledging the traditional limitations, the state supreme court in *Frances T.* held that the director defendants could be personally liable for negligence. The ruling was reached in the context of particularly egregious facts and was carefully circumscribed so that it applies only to negligence cases that also involve personal injury.

In *Frances T.*, the plaintiff brought suit against the condominium owner's association for the condominium project in which she lived and individual members of its board of directors for injuries suffered when she was molested, raped, and robbed on the premises of the project. The trial court sustained all of the defendants' general demurrers to the negligence claim without leave to amend, and the plaintiff appealed. The supreme court reversed.

The basis for the plaintiff's negligence claim against the defendants was the lack of exterior lighting on the night of her attack. The plaintiff alleged in her complaint that, throughout the year in which her attack occurred, the condominium project was subject to an exceptional crime wave. All the project's residents, as well as the board, were aware of and concerned about this significant increase in crime on the premises. The condominium association's newsletter, distributed to residents and directors, published details about the problem and possible protective measures to address it. Earlier in the year, the board began to investigate what could be done to improve the lighting in the project. The plaintiff's unit was burglarized about five months before her attack, and four months before her attack she and other residents of the project made a formal request to the project manager, with a copy to the board, for new lighting to be installed as soon as possible. The plaintiff submitted another written request before her attack because the board had still not taken action. When this request went unheeded, the plaintiff installed additional exterior lighting, but the project manager told the plaintiff to remove the lighting because it violated the project's covenants, conditions, and restrictions. After initially refusing to comply with the manager's request, and after appearing at a board meeting where she requested permission to maintain her lighting, the board specifically instructed her to remove the exterior lighting. As a result, "her unit was in total darkness on October 8, 1990, the night she was raped and robbed."[26]

The supreme court held that the plaintiff had pleaded facts sufficient to state a cause of action for negligence against both the condominium association and its individual directors. The court discussed at some length the plaintiff's claim against the directors individually. Citing its prior decision in *Haidinger-Hayes*, the court began by noting that "corporate directors cannot be held vicariously liable for corporation's torts in which they do not participate. Their liability, if any, stems from their own tortious conduct, not from their status as directors or officers of the enterprise."[27]

The court recalled that in its decision in *Haidinger-Hayes*, it had discussed "the traditional limitations on a corporate officer's or director's liability for negligence." The first limitation was that "no special agency relationship imposed personal liability on the defendant corporation's president for failing to prevent economic harm to the plaintiff corporation, a client of his principal." This limitation "reflected the oft-stated disinclination to hold an agent personally liable for economic losses when, in ordinary course of his duties to his own corporation, the agent incidentally harms the pecuniary interests of the third party."[28]

The second traditional rule to which the *Frances T.* court referred was the *Haidinger-Hayes* court's admonition that "directors are not personally liable to third persons for negligence amounting merely to a breach of duty the officer owes to the corporation alone. '[T]he act must also constitute a breach of duty owed to the third person....More must be shown than breach of the officer's duty *to his corporation* to impose personal liability *to a third person* upon him.'"[29] Thus, "a distinction must be made between the director's fiduciary duty to the corporation (and its beneficiaries) and the director's ordinary duty to take care not to injure third parties. The former duty is defined by statute, the latter by common law tort principles."[30]

Regarding the facts of the case before it, the court in *Frances T.* explained:

> [I]t would be insufficient to allege that because the directors had a duty as agents of the Association to manage its property

> and conduct its affairs, that they also necessarily owed a *personal duty* of care to plaintiff regardless of their special knowledge of the allegedly dangerous condition that led to her injury. As this court suggested in *Haidinger-Hayes*, such a broad application of agency principles to corporate decision makers would not adequately distinguish the director's duty of care to third persons, *which is quite limited*, from their duty to supervise broad areas of corporate activity. Virtually any aspect of corporate conduct can be alleged to have been explicitly or implicitly ratified by the directors. But their authority to oversee broad areas of corporate activity does not, without more, give rise to a duty of care with regard to third persons who might foreseeably be injured by the corporation's activities.[31]

The court concluded that the plaintiff's complaint alleging that each of the directors participated in the tortious activities was sufficient to withstand a demurrer. The court proceeded to hold, however, that only the directors who actually voted for the commission of the tort may be held personally liable.[32]

Liability imposed upon agents for active participation in the tortious acts of the principal have been mostly restricted to cases involving physical injury, not pecuniary harm, to third persons. The *Frances T.* court reiterated the statement in *Haidinger-Hayes* that the reason liability in the latter case was denied was because "the harm in that case was pecuniary in nature and resulted from good faith business transactions."[33]

Questionable Expansion

The Second District Court of Appeal decision in *Michaelis* v. *Benavides*[34] merits discussion because of its apparent expansion of *Haidinger-Hayes*. In *Michaelis*, the plaintiffs hired a general contractor to build their home. The general contractor subcontracted the construction of the patio and driveway to A&J Stamped Concrete, Inc., and defendant Anthony Benavides was the president of A&J. Benavides personally made the construction decisions for the patio and driveway.

After construction was completed, the patio developed severe cracks and other problems. In addition, the plaintiffs alleged that the driveway was four feet narrower than specified, and the driveway drains were incorrectly placed, causing rain water to flood. This, in turn, "posed a hazard to the home's structural integrity and caused a safety hazard to persons entering or leaving" the home.

At the hearing on the defendant's motion for nonsuit, the defendant generally stipulated that he had been negligent in constructing the patio and driveway. Relying on *Haidinger-Hayes*, the trial court held that the plaintiffs had no negligence claim against the defendant because the plaintiff had only suffered economic losses.

The court of appeal reversed. In construing *Haidinger-Hayes*—and also *Frances T.*—the court rejected the respondent's distinction between damage to property and personal injuries. Still, the court also observed, somewhat cryptically, that "[it] is not unlikely that personal injury could have resulted from the unsafe conditions caused by the structurally defective patio and driveway."[35] Does this mean that an officer may be liable for property damage only if the damage created a risk of personal injury?

The *Michaelis* court's construction of *Haidinger-Hayes* is questionable. The supreme court in *Haidinger-Hayes* seemed to draw a clear line between liability for purely pecuniary harm and liability for personal injury. A standard that would also impose liability on officers and directors who negligently create the risk of personal injury would be a significant expansion of the standard of liability enunciated in *Haidinger-Hayes*.

California courts have opened the door wide to claims for intentional torts against officers and directors. Indeed, the misconduct need not even be active; the knowing failure to act in the face of intentional misconduct by others in the corporation may be enough to give rise to personal liability.

With respect to negligence claims, on the other hand, the door generally has been shut to all but those that involve personal injury claims. Whether *Michaelis* is the first decision to pry open the door for other types of negligence claims or simply a bad decision with ultimately no precedential value remains to be seen. ■

---

[1] Frances T. v. Village Green Owners Ass'n, 42 Cal. 3d 490, 504 (1986).
[2] *Id.* at 508-09.
[3] PMC, Inc. v. Kadisha, 78 Cal. App. 4th 1368, 1381 (2000).
[4] *Id.* at 1382.
[5] Provident Land Corp. v. Bartlett, 72 Cal. App. 2d 672, 687-88 (1946) (quoting 3 FLETCHER, CYCLOPEDIA OF CORPORATIONS 567).
[6] Croeni v. Goldstein, 21 Cal. App. 4th 754, 758 (1994).
[7] Spahn v. Guild Indus. Corp., 94 Cal. App. 3d 143, 157 n.9 (1979) (corporation's officers and directors held individually liable for fraud).
[8] PMC, 78 Cal. App. 4th 1368.
[9] *Id.* at 1372.
[10] *Id.* at 1381 (citations omitted).
[11] *Id.* at 1383 (citing Bancroft-Whitney Co. v. Glen, 64 Cal. 2d 327, 353 (1966)).
[12] *Id.* at 1384, 1387 (citing Components for Research, Inc. v. Isolation Prods. Inc., 241 Cal. App. 2d 726, 729-30 (1966)). *See also* McClory v. Dodge, 117 Cal. App. 148, 152-53 (1931) (citing CIV. CODE §3426 and noting that misappropriation of trade secrets is an intentional tort).
[13] *Id.* at 1385. *See* People v. Toomey, 157 Cal. App. 3d 1, 15-16 (1984) (unfair business practices and false advertising).
[14] Granoll v. Yackle, 196 Cal. App. 2d 253 (1961).
[15] *Id.* at 257 (quoting Hirsch v. Phily, 73 A. 2d 173, 177 (N.J. 1950)).
[16] *Id.* at 257.
[17] Jackson v. Ryder Truck Rental, Inc., 16 Cal. App. 4th 1830, 1837 (1993).
[18] United States Liab. Ins. Co. v. Haidinger-Hayes, Inc., 1 Cal. 3d 586 (1970).
[19] *Id.* at 594.
[20] *Id.* at 595.
[21] *Id.*
[22] PMC, Inc. v. Kadisha, 78 Cal. App. 4th 1368, 1387 (2000).
[23] Self-Insurers Sec. Fund v. Esis, Inc., 204 Cal. App. 3d 1148 (1988).
[24] *Id.* at 1162.
[25] *Id.* at 1162-63.
[26] Frances T. v. Village Green Owners Ass'n, 42 Cal. 3d 490, 498 (1986).
[27] *Id.* at 503 (citation omitted).
[28] *Id.* at 505.
[29] *Id.* at 505-06 (citing United States Liab. Ins. Co. v. Haidinger-Hayes, Inc., 1 Cal. 3d 586, 595 (1970) (emphasis in original)).
[30] *Id.* at 506.
[31] *Id.* at 506-07 (emphasis in original).
[32] *Id.* at 511.
[33] *Id.* at 505.
[34] Michaelis v. Benavides, 61 Cal. App. 4th 681 (1998).
[35] *Id.* at 687