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## D&O Liability For Wages, WARN Act Violations

*Law360, New York (February 20, 2009)* -- As the current financial markets have reminded us, attempts to predict the future are fraught with peril.

Businesses that survived the Great Depression have imploded with frightening speed. Businesses once described as “too big to fail” are now circling the drain. While some businesses remain well-positioned to weather the storm, countless others are struggling to remain afloat.

Facing an uncertain future, now is a good time for officers and directors of distressed companies to ask themselves: “What is the worst that can happen?”

This article explores just one way a struggling business can negatively impact its officers and directors: potential personal liability for unpaid wages and WARN Act violations.

In normal times, the question does not often arise. In these times, it is one that officers and directors cannot afford to ignore.

### **The Business Case for Not Paying Wages**

When a company struggles to survive, there may come a time when it can no longer meet payroll.

Most executives do not have to worry about Congress asking them to cut their salary to \$1 per year (as it recently did to the executives of Ford, GM and Chrysler), but some executives may entertain thoughts of reducing or delaying their own salary to preserve cash.

In particularly dire situations, they may ask the company’s employees to share in the belt-tightening.

The crux of the employment bargain is payment of wages in return for the provision of labor. In other words, employees are not going to work for free forever.

When the money runs out, however, companies may attempt to proffer a new bargain to employees: continue working temporarily without pay in the hopes of saving the company (and with it, the employees' jobs).

If employees have no other job options, this prospect of continued employment may be preferable to the certainty of losing their jobs if they do not help the company survive.

This might well be a fair trade, particularly if the crisis is one of liquidity rather than solvency. That the trade is fair, however, does not necessarily mean that the law will allow it.

Consider an example: Suppose that a faltering company continued operations in the belief that an imminent transaction would solve its financial problems, but it ultimately wound up in bankruptcy.

Employees who worked without pay may be no worse off financially than if they had lost their jobs sooner. They traded their time and efforts for the prospect of continued employment. They knew nonpayment was a possible outcome.

The plaintiffs' bar will see it differently. Like the gambler who asks the casino for a refund because he lost his bet, plaintiffs' attorneys inevitably will seek to alter the deal after-the-fact.

Their perspective is simpleminded but straightforward: the employees worked, so they are entitled to be paid. And like sharks sensing blood in the water, plaintiffs' attorneys will hone in on the deepest pockets available.

Normally that is the company itself. When the company fails, however, plaintiffs' attorneys may go after the company's officers and directors — if they can.

## **Federal Law**

Under the Fair Labor Standards Act (the "FLSA"), a worker's "employer" is liable for the payment of wages. An officer or director may breathe a sigh of relief when considering the typical definition of an employer.

Under the FLSA, however, an "employer" is defined broadly as "any person acting directly or indirectly in the interest of an employer in relation to an employee." 29 U.S.C. § 203(d).

Leaving aside the inherent ambiguity of using the term "employer" in a definition of that very term, the expansive redefinition of the term "employer" is immediately apparent.

Officers and directors are persons “acting directly in the interest of” companies in relation to employees.

Under the terms of the statute, therefore, officers and directors may be considered “employers” who are liable for unpaid wages — even though no one would ordinarily think officers and directors are “employers.”

Federal decisions interpreting the FLSA are unfazed by the absurdity of calling officers and directors “employers.” Sitting en banc, the Ninth Circuit held that corporate officers and directors under certain circumstances may be held personally liable under the FLSA in *Lambert v. Ackerley*, 180 F.3d 997 (9th Cir. 1999).

In *Lambert*, there were two individual defendants: the CEO of the operating company and the COO of the operating company’s parent corporation. They argued that they could not be held personally liable “because they [were] not ‘employers’ within the meaning of the FLSA.” *Id.* at 1011.

The Ninth Circuit disagreed. Purporting to apply the plain language of the FLSA, the Ninth Circuit held that individuals are “employers” under the statute:

“We have held that the definition of ‘employer’ under the FLSA is not limited by the common law concept of ‘employer,’ but ‘is to be given an expansive interpretation in order to effectuate the FLSA’s broad remedial purposes.” *Id.* at 1011-12.

Those purposes, apparently, are to ensure that employees get paid — even if the courts have to seize money from people who should not be responsible for the payment under the guise of calling them “employers.”

While the decision attempts to clothe itself in the language of the statute, it is impossible to escape the conclusion that individual liability results more from judicial activism than Congressional design. The statute says that “any person” acting “directly or indirectly” in the interest of an employer is an “employer.”

That definition undoubtedly is broad enough to cover middle managers and line-supervisors who act in a company’s interest with respect to employees they supervise.

Yet even the Ninth Circuit is unprepared to hold that the assistant supervisor working the night shift at a fast-food restaurant — who may not make much more than minimum wage — is individually liable for the wages of all of the other workers.

Thus, rather than applying the statutory language, the Ninth Circuit ultimately devised its own rules.

Specifically, the Ninth Circuit approved an instruction to “the jury that it could find the individual *Ackerleys* liable only if it determined that they had a ‘significant ownership interest with operational control of significant aspects of the corporation’s day-to-day

functions; the power to hire and fire employees; the power to determine salaries; the responsibility to maintain employment records.” Id. at 1012.

These criteria applied by the Ninth Circuit are nowhere to be found in the FLSA’s definition of “employer.”

Instead, the Ninth Circuit’s en banc decision adopts criteria applied by an earlier Ninth Circuit panel decision, *Bonnette v. California Health & Welfare Agency*, 704 F.2d 1465 (9th Cir. 1983).

That decision, in turn, observed that, “[i]n varying combinations, these factors have been considered by other courts for the same purpose.” Id. at 1470.

While the Ninth Circuit often adopts controversial positions, in this case it is not alone. Federal courts in other jurisdictions likewise have found officers and directors individually liable for unpaid wages under the FLSA under similarly-fabricated (although not necessarily similar) tests.

See, e.g., *Donovan v. Agnew*, 712 F.2d 1509, 1511 (1st Cir. 1983) (“The overwhelming weight of authority is that a corporate officer with operational control of a corporation’s covered enterprise is an employer along with the corporation, jointly and severally liable under the FLSA for unpaid wages.”); *Donovan v. Sabine Irrigation Co. Inc.*, 695 F.2d 190, 194-95 (5th Cir. 1983) (“[W]e perceive the parameters of § 203(d) [of the FLSA] as sufficiently broad to encompass an individual who, though lacking a possessory interest in the ‘employer’ corporation, effectively dominates its administration or otherwise acts, or has the power to act, on behalf of the corporation vis-à-vis its employees.”).

As these decisions make clear, officers and directors cannot take any comfort in the application of particular factors to determine their personal liability.

The Ninth Circuit requires a “significant ownership interest” while the Fifth Circuit has found personal liability even where a “possessory interest” is “lacking.”

These differences should not be particularly surprising since they are not based on the statutory language. The only statutory limitation is that the individual act “directly or indirectly” on behalf of the company. Since that covers basically everybody, it is essentially left to the whims of judges to decide whether an officer or director should be held liable in a particular case.

From a planning standpoint, the only safe havens are to ensure wages get paid, or to abandon ship before they are not.

There is, however, at least one silver lining in these decisions. The courts do not hold that officers and directors necessarily are liable for unpaid wages, but only that officers and directors potentially may be liable.

See *id.* at 194 (“Whether a party is an employer or joint employer for purposes of the FLSA is essentially a question of fact.”).

Although individual liability is a possibility, plaintiffs may have difficulty establishing it in practice. Officers and directors can make arguments to limit or entirely avoid individual liability in particular cases.

## **California Law**

Frequently known for pioneering laws that are employee-friendly but hostile to businesses, California law charts a surprisingly rational course in this instance.

In *Reynolds v. Bement*, 36 Cal. 4th 1075 (2005), the California Supreme Court observed that, “[U]nder the common law, corporate agents acting within the scope of their agency are not personally liable for the corporate employer’s failure to pay its employees’ wages.” *Id.* at 1087.

“This is true regardless of whether a corporation’s failure to pay such wages, in particular circumstances, breaches only its employment contract or also breaches a tort duty of care.” *Id.*

Thus, the court held that a “plaintiff cannot state a [California Labor Code] section 1194 cause of action [for unpaid overtime] against the individual defendants.” *Id.* at 1087-88.

Unfortunately, the court significantly undercut its own decision by characterizing its decision as a “narrow holding that plaintiff cannot ... state a section 1194 cause of action [for unpaid overtime] against the individual defendants.” *Id.* at 1088-89.

Section 1194 (unlike Section 203 of the FLSA) does not contain any definition of “employer” that modified the common-law concept of employer to include individuals acting on a company’s behalf.

The Court left open the possibility, however, that officers and directors could be held liable under other legal theories, which has given rise to significant copycat litigation.

So far, the California Courts of Appeal have resisted plaintiffs’ attempts to exploit the opening left by *Reynolds*.

In *Jones v. Gregory*, 137 Cal. App. 4th 798 (2006), the plaintiff asserted other California claims and attempted to rely on the fiction employed by federal decisions that officers and directors somehow be treated as “employers.”

The court rebuffed the attempt, holding: “As with section 1194, so too none of the Labor Code provisions plaintiffs rely upon in their complaint — sections 201, 202, 203, 227.3, 1194.5, or 2802 — define ‘employer.’”

Hence, as Reynolds explained, the FLSA, Lopez and other federal authority plaintiffs extensively cited are simply beside the point. And the presumption is that the common law definition of an employer applies, precluding personal liability for corporate agents.” Id. at 804.

Significantly, in Jones, the Court of Appeal held that individuals are not liable for the obligations to pay wages upon termination of employment, accrued but unused vacation or business expense reimbursements.

In *Bradstreet v. Wong*, 161 Cal. App. 4th 1440 (2008), the Court of Appeal again was faced with the question “whether defendants, as the shareholders, officers or managing agents of the Wins Corporations, may be held personally liable for the many violations of the Labor Code that occurred when these employees were not paid, and the corporations went out of business.” Id. at 1449.

In that case, in addition to Labor Code violations, the plaintiffs relied on California’s Unfair Competition Law (“UCL”), which broadly prohibits unfair and unlawful business practices.

That allegation was clever, because “it is well established that an owner or officer of a corporation may be individually liable under the UCL if he or she actively and directly participates in the unfair business practice.” Id. at 1458.

But the Court of Appeal was not fooled, and held that “it does not necessarily follow that all of the remedies imposed with respect to the corporation are equally applicable to the individual.” Id.

As the Court of Appeal explained, “[t]he problem with requiring defendants, rather than the Wins Corporations, to pay unpaid wages as restitution is that the labor intervener performed was not for defendants personally, but for the employers, the Wins Corporations.

Defendants did not personally obtain the benefit of those services, and the duty to pay wages was owed by the corporations as employers, not by defendants as owners, officers or managers.” Id. 1460.

## **WARNings**

Unfortunately, rational California laws go only so far.

While the California decisions could serve as a good model for revisions to federal law, they can create a false sense of security for officers and directors: even if there is no liability under state law, officers and directors can still be held liable for some unpaid wages under the FLSA.

Furthermore, it is unclear whether California can be relied upon to continue serving as the voice of reason in this debate. The federal Worker Adjustment Retraining and Notification Act (“WARN”) provides an example of one unsettled area where California law could come out worse than federal law.

WARN requires employers, in certain circumstances, to give employees 60 days notice of a plant closing or mass layoff. If employers fail to give such notice, they will be required to give the employees an additional 60 days of pay and benefits following their terminations.

Unlike the FLSA’s overly broad definition of “employer,” WARN defines “employer” to mean “any business enterprise that employs” 100 or more employees. 29 U.S.C. § 2101.

Without the statutory fiction that officers or directors are “employers,” federal courts generally have not sanctioned individual liability under WARN except in circumstances where the plaintiffs can pierce the corporate veil or rely upon the alter ego doctrine. See generally *International Union, Aut., Aerospace & Agric. Implement Workers v. Aguirre*, 410 F.3d 297, 302-03 (6th Cir. 2005).

Yet California’s own version of the WARN Act ominously defines “employer” as “any person ... who directly or indirectly owns and operates a covered establishment.” Cal. Lab. Code § 1400.

The definition practically begs plaintiffs’ lawyers to file suit against officers and directors to test the true limits of Reynolds.

To sum up: In a dim ray of sunshine in this otherwise gloomy article, none of the foregoing means that an officer or director will be held liable for wages. In light of the ill-defined and loosely-applied standards, an officer or director already behind this particular eight-ball should at least have a fighting chance.

But it is clear that there is substantial potential for individual liability. A healthy sense of prudence would suggest, therefore, that officers and directors think twice before continuing to operate a business that lacks the cash to make payroll.

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