The Expanding Personal Liability of Corporate Managers and Gambino

By Edward S. Margolis

Frank, an old and valued client of the firm, has arranged a late afternoon appointment. Although he hasn't mentioned the reason for the consultation, you sense that it will not be an occasion for celebration. For a few years now Frank's small manufacturing business has been declining. The business suffers both from new and energetic competition and from management problems that arose with the death of Frank's brother, whose spouse now controls 49 percent of the corporation's stock from a retirement condominium in Florida.

Your meeting confirms your suspicions. The corporation is insolvent and will soon be unable to meet its payroll of organized union workers unless there is an infusion of cash. The inventory, receivables, and fixtures are already secured by bank loans, and the only ready source of collateral is Frank's considerable personal worth, accumulated over the many years when the business prospered. Against your best advice, he wants to keep the business afloat. He will risk part of his wealth, but wants to assure himself that he will be able to get out without depleting his retirement reserves if the business cannot be turned around. He seeks your advice.

You explain to him that long before you came to the firm, measures were taken to protect him from personal liability. Thirty years before his current problems the family business was incorporated by your firm. Each year the firm had seen to it that an annual report was filed as required by the secretary of state and that franchise taxes were paid. The corporate minute book was up to date. In short, everything in connection with the corporation looked normal; and, indeed, the limited liability which flows from this normal condition is fundamental to corporate law. The fact that he was the sole chief operating officer and a 51 percent stockholder will not make him personally liable for the debts of the corporation.' But you explained that though this is the general rule, you had to ask Frank a few questions about the corporate operation to assure yourself that he would be protected.

The Alter Ego Theory

In the eyes of the law, a corporation and its shareholders are separate legal entities; however, when such separation will "defeat some strong equitable claim," the courts have employed the alter ego doctrine to circumvent it. In Illinois, the alter ego doctrine applies when two conditions are met:

1. The unity of interest and ownership is so strong that t he separate personalities of corporation and individual no longer exist;
2. Maintaining the fiction of independent existence sanctions fraud or promotes injustice.

The decision to "pierce the corporate veil" and apply the alter ego doctrine is an equitable one that depends upon the circumstances of each case. Since one of the chief attractions of the corporate form is insulation from personal liability, courts have been reluctant to remove this protection. Although you're satisfied that Frank has done nothing to justify stripping away his personal protection under the time honored common law standard, recent developments in the law impel you to ask a few other questions.

The Statutory Exceptions

One potential problem for Frank is that corporate managers can be held liable for their failure to perform a statutory duty. Under the Internal Revenue Code, employers are required to deduct and withhold taxes. A corporate president who supervises business affairs, signs the corporate checks, and confers from time to time about paying various debts while knowing that withholding taxes are overdue can be personally charged with the duty to collect and pay withholding taxes." Likewise, under the Illinois Income Tax Act, employers are liable for withheld taxes and an officer or an owner of a corporation who has control, supervision, or responsibility for filing returns under the State Retailer's Occupation Tax is personally liable for failure to file a return or pay the Department of Revenue.

In a recent case, an Illinois appellate court has held that under the Illinois Wage Collection Act, an employer who knowingly and willfully deducted money from payroll checks and failed to pay it to a union trust fund was personally liable, even though the company was without funds to satisfy arrearages. Perhaps the most startling example of individual liability for a corporate function is People v. Film Recovery Systems." In a bench trial. Judge Ronald Brooks found three officers of Film Recovery Systems guilty of murder for failure to warn and adequately protect their employee, an undocumented Polish immigrant, from a work related hazard which the court found that they knew to be deadly. This case is currently on appeal.

Gambino and Beyond

Once you determined as best you could that Frank kept up his obligations to federal and state taxing authorities and that there were no Film Recovery Systems skeletons lurking in the closet, it seemed that his corporate shield was intact - or was it? While that was a valid opinion well into 1987, the case of Gambino v Index Sales Corporation," handed down in November of that year was to become, at least for a while, a matter of serious concern to attorneys with a client in Frank's circumstances.

In Gambino, Judge Shadur held that the definition of "employer" under the Employee Retirement Income Security Act, "ERISA," includes controlling corporate figures who choose to pay other corporate debts rather than meet federal statutory obligations to corporate employees. Put another way, any employer who fails to contribute to a welfare or pension plan is exposed to personal liability, even if he or she elects to make payments for rent, utilities, raw materials, taxes, or other expenses necessary to keep the business alive.

The implications are clear: an employer should think twice before attempting heroic measures to save a company if they include cutting back on welfare payments.

Gambino includes a lengthy, detailed analysis that favors protecting employees over the time-honored business concept of insulating corporate managers from personal liability, in response to what the court views as congressional intent. In his decision, Judge Shadur notes that two circuits, the third"' and the ninth," take a contrary view, but nonetheless finds that the first circuit in Donovan v Agnew "points the way" to his conclusion. Judge Shadur's opinion has been followed in the Northern District of Illinois by Judge Zagel" and Judge Moran. Judge Grady" has also found individual liability using a "plain meaning" analysis.

The Impact of Additional Circuit Court Authority

Gambino rests on an analogy between the language of ERISA and the Fair Labor Standards Act, in support of which Judge Shadur cites Donouail v. Agnew. This is the crux, the legal underpinning of the Gambino decision. However, early in 1988, the first circuit - the Donovan court - held in Massachusetts Laborers Health and Welfare Fund v Starrett Paving"' that Peter Starrett individually was not an employer obligated to make contributions to a multi-employer plan and was thus not liable under section 1145 of ERISA. Starrett was the first circuit court opinion to come down after Gambino.

In Starrett, the first circuit court clearly "pointed the other way." It specifically distinguishes its own decision in Doilovail by noting that "an ERISA-type fund is not necessarily as helpless when faced with a financially shaky, but closely held, corporation as is a worker seeking payment of a minimum wage. . . . [Thus], the former may be in greater need of federal protection against such a corporation's owner than the latter.""

The first circuit in Starrett squarely confronts the fear expressed in Gambino that a literal reading of section 1145 would not permit piercing of the corporate veil:

> **We do not think this is so. When state law pierces the corporate veil, where the owner is the corporation's alter ego, where state law makes the owner liable, it is fairly easy to say that the owner is the corporation and the owner is, therefore, an employer (under ERISA's definition) "who is obligated" (under state law) "to make contributions to a pension plan." Indeed, in such a case, he is an employer already obligated to make contributions."**

Later that year, the D.C. circuit court joined the first, third and ninth circuits, ruling in International Brotherhood of Painters v George A. Kracher that corporate shareholders and CEOs were not personally liable for a corporation's delinquent pension contributions unless the conduct would otherwise justify piercing the corporate veil. While this decision is significant for the careful distinctions it draws between the operation of ERISA and the FLSA and its extensive references to the legislative history of ERISA, perhaps its most interesting aspect is its verbatim restatement of the rule of Connors v P & M Coal Company, -"' a decision in which Anton Scalia, now of the United States Supreme Court, joined.

In Gambino, the court draws a negative inference from a statement in Connors that it was not deciding the question of individual liability for delinquent contributions (under Title 1) but was only holding that employers were not liable for withdrawal liability (under Title IV). Once again, as the first circuit did in Starrett, the D.C. circuit has clarified a previous opinion and has come out squarely against the Gambino extension of individual liability to corporate officers or shareholders.

Although the seventh circuit has not ruled on this issue within the narrow context of an ERISA case. Judge Easterbrook in his opinion in Levit v Ingersol Rand Financial Corporation states in the strongest terms that he is not persuaded by the analysis of manager's liability as set out in Gambino. Judge Easterbrook's specifically cites the authority of the Stariett decision and quotes the general counsel of the Pension Benefit Guaranty Corporation who has concluded in an opinion letter that ERISA does not address shareholder or officer liability. In summing up the law on the subject Judge Easterbrook states that "it would take a

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The effects of Starrett and Kraclier have also reached the district court level where Gainhino had held swav since November of 1987. Judge Brian Barnett Duff in Plumbers Pension Fund Local 130 U.A. v Niedrich, (now on appeal before the seventh circuit) examines the Gainhino case and the later circuit court opinions and concludes that unless there are grounds to pierce the corporate veil or the corporation is the alter-ego of the controlling individual, the individual is not liable under section 1145 unless he or she individually is a party to the collective bargaining agreements

Likewise, Judge James B. Moran in Serembus v Comfort Lines, Inc., in a slip opinion dated May 23, 1989, granted the individual defendant's motion for summary judgment and dismissed the lawsuit against the defendant after considering the additional authority of Starrett and Kracher, in effect reversing his previous decision reported in the case.

The Future of Personal Liability

The trend toward increasing personal liability for corporate managers like Frank is obvious, despite an apparent retreat from corporate manager liability in ERISA contribution cases. While the rigid requirements for piercing the corporate veil remain for the strictly debtor-creditor relationship, more and more courts find personal liability where they perceive a social duty that transcends the corporate market place. Where the health and welfare ot the worker or society come into play, we can look for an expansion of personal responsibility and the abandonment of traditional notions that have protected clients like Frank in the past.

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1. *Conners v. P&M Coal Co. 801 F2d 1373 (DC Cir 1986).*

2. *Koch Refining v. Farmers Union Cent. Exchange, Inc., 831 F2d 1339 (7th Cir 1987).*

3. *Stap v. Chicago Aces Tennis Team, 63 Ill App 3d 23, 379 NE2d 1298 (1st D 1978). Also see Michael S. Jordan, Representing a Client Dealing with a Suspicions Entity, Chi Bar Assoc Young Lawyers Section) at p6 (May-June 1981).*

4. *Koch Refining, 831 F2d 1339.*

5. *Sumner Realty Co. ;' Willcott, 148 Ill App 3d 497, 449 NE2d 554 (5th D 1986).*

6. *Monday v U.S., 421 F2d 1210 (7th Cir 1970), cert denied 400 US 821 (197(1), on remand 342 F Supp 1271 (EDWis 1972).*

7. *Johnson v Western Amusement Corp., 157 Ill App 3d 873, 511) NE2d 991 (1st D 1987).*

8. *Nos 83-11091 and 84-5064 (Ill Cir Ct, Cook Co, June 14,1985).*

9. *673 F Supp 1450 (ND Ill 1987).*

10. *Solomon v. Klein, 770 F2d 352 (3d Cir 1985). ,li>Operating Engineers Pension Trust v. Reed, 726 F2d513(9thCir'1984).*

11. *712 F2d 1509 (1st Cir 1983).*

12. *Glover v Hartmann Freight Lines, 86 C 5004, slip optND Ill Jan 15, 1988).*

13. *Serembus, v Comfort Lines, 87 C 5355, slip op (ND Ill April 5, 1988).*

14. *Laborers Pension fund v. Bakke Construction Co., 86 C 5004, slip op (ND Ill Nov 9, 1987).*

15. *845 F2d 23 (1st Cir 1988).*

16. *845 F2d at 26.*

17. *Id.*

18. *F2d 1546 (DC Cir 1988).*

19. *801 F2d 1373(DC cir 1988).*

20. *874 F2d 1186 (7th Cir 1989) The trustee in bankruptcy sought to recover as preferences payments to various pension funds on a theory that such payments were really on behalf of insiders, the managers of the debtor corporation. Judege Easterbrook held that when the funds had personal guarantees from the managers of the debtor corporation, the payments were preferences but distinguished whost funds without guarantees, were not "employers obligated to pay" under ERISA, citing Starrett.*

21. *701 F Supp 651 (ND Ill 1988). Appellant will no doubt strive to present a "compelling argument" to sway the seventh circuit from a course which in Levit seems to be in line with other circuits that have decided tile question.*