

Extra Reading

The Active Participation Doctrine

What is a Corporate Officer's Personal Liability?

By Brian Hunt

Perhaps the single most important factor in selecting the corporate form is the shield from personal liability afforded to corporate officers. Of course, although a corporation is recognized as a separate legal entity, the corporation can act only through its officers. The general premise is that corporations are to be encouraged to take risks and behave in an entrepreneurial fashion, and that the imposition of personal liability would “chill” the corporate officers. However, the general premise has limitations, some of which are set forth in *IOS Capital, Inc. Phoenix Printing, Inc.*, 283 Ill. Dec. 640(4th Dist. 2004).

Russell was majority owner of Colortech, and held a position on the three-member Board of Directors. He was not active in the daily business of Colortech; Legener was the company president and managed the daily business. In July 1998, Russell authorized Legener to enter into a five-year written agreement for the lease of two copiers from IOS. Legener signed the agreement on behalf of Colortech and as a personal guarantor. The agreement required monthly payments by Colortech and provided, in the event Colortech defaulted, that the company would pay all amounts due under the agreement plus a 5-percent penalty on overdue amounts and attorney’s fees. It also stated that the system would be returned to IOS at Colortech’s expense.

Colortech received the copiers and made monthly payments through May of 2000. However, Colortech retained the copiers even after it stopped making payments and continued to use them, making over 700,000 copies and generating \$49,000 in revenue. Although IOS demanded the copiers’ return, Colortech refused.

In October 2000, Russell discovered that Colortech had stopped payments, and told Legener that he should work out a deal with IOS, but no deal ever transpired. IOS commenced legal action, and Colortech was served with summons in December 2000. Thereafter, and before March 2001, Russell met with his attorneys, who advised him not to return the copiers. Russell took that advice and directed Legener accordingly. In March 2001, Russell fired Legener as an employee,

officer and director.

In June 2002, IOS proceeded with a bench trial on a conversion action against Russell only. In order to establish a tort of conversion, IOS had to prove: (1) a right in the property; (2) a right to immediate possession; (3) wrongful conduct by the defendant; and (4) a demand for possession. The trial judge found against Russell and awarded \$140,000 in damages, including attorney's fees, prejudgment interest and punitive damages of \$49,000 for the revenue generated by Colortech while it was not making lease payments.

On appeal, the Appellate Court held that the trial judge's determination as to conversion was not against the manifest weight of the evidence. However, the Court reached a different conclusion as to Russell's personal liability.

The Court began by noting that, although corporate officers are generally not liable for corporate obligations, they may be liable for any tort of the corporation in which they actively participate. Therefore, the Court concluded, in the context of the case, an officer or director is liable in conversion only where he/she actively participates therein. The Court also noted that not just any participation by the corporate officer will suffice. Instead, personal liability for actions taken on behalf of the corporation attaches only when the officer or director is alleged to have taken part in the wrongful act *initially giving* rise to the corporation's liability. The Court stated that, based on the evidence at trial, Russell did not give the order to retain the copiers until sometime between December 5, 2000 and March 2001 and, therefore, concluded that his participation in the conversion did not give rise to the corporation's liability.

The Court also held that, even if Russell had actively participated, he would not be liable in tort if his conduct were privileged. The Court stated that, because officers and directors owe fiduciary duties of undivided and unselfish loyalty to the corporation, their freedom of action aimed toward corporate benefit should not be curtailed by undue fear of liability. The Court further stated that holding an officer or director liable for conversion of property which is subject to a contract would impose liability for corporate debts under the contract and, therefore, concluded that Russell's actions were conditionally privileged. The conditions were that Russell neither acted without justification nor maliciously, and the Court concluded that IOS had established neither.

The Court also addressed Russell's reliance on the advice of legal counsel, noting that an officer or director of a corporation should not be held liable for the performance of his duties if performed in good faith and in a manner he reasonably believes to be in the best interest of the corporation. Although the Court noted that an officer or director may not blindly accept legal counsel's advice to avoid liability, the officer or director may rely on such advice when he/she does not have knowledge of his actions causing such reliance to be unwarranted. The Court concluded that, because the record gave no indication that Russell had any reason to believe the legal advice given was not sound, he was entitled to rely on counsel's advice directing Colortech to retain the

copiers.

As the *IOS Capital* decision makes clear, corporate officers do need to be cognizant of their potential personal liability. In addition, those seeking to impose personal liability on corporate officers must appreciate the significant hurdles in their path. While the circumstances in which personal liability will be imposed are necessarily fact-specific, all will be well served by keeping the applicable principles in mind.

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