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Whose Fraud Is It Anyway?

Liability

The Active Participation Doctrine
Can corporate directors be held accountable for a colleague's fraud?

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When a company director commits fraud, how extensive is the trickle down effect? It's a question that has kept more than one director up at night. A 2010 decision, *Zahl v. Krupa,* sheds some light on the issue.

As a general rule, corporate directors aren't personally liable for the acts of other officers or directors merely because of their status as directors. However, in certain circumstances, Illinois law does impose liability. For instance, a director might be personally liable for the acts of subordinates if he/she fails to exercise ordinary care, and is personally liable for the acts of co-equals (namely, co-directors) only if he/she participates actively or passively in the acts (whether by knowing or reckless action or omission).

In the case of *Zahl v. Krupa*, Krupa began working as a salesman with Jones & Brown in 1973, rising to the position of vice president of sales, board member and, ultimately, president in 2003. By 2000 he had met Zahl, whom he had dated and with whom he maintained a friendship. He represented to Zahl that, in addition to steel manufacturing, Jones & Brown "made investments." In 2000, Krupa informed Zahl that Jones & Brown had created an investment fund to raise money for business expansion and that friends could invest under the director's name.

Krupa advised that Jones & Brown "guaranteed" the investment (which would be "short term") at a rate of more than 11 percent, and asked for the funds in cash. Krupa handwrote the terms of the agreement on Jones & Brown letterhead. Zahl didn't ask for any additional documentation.

Krupa returned the first investment of $10,500 with interest, as well as a second investment of $66,000. Then, in late 2002, Krupa advised that the fund was open again "probably for the last time," and Zahl invested a further $160,000. Zahl testified that all of the investment offers, as well as the receipts and repayments, were made at Krupa's Jones & Brown office.

Creighton had been a board member at Jones & Brown since the 1960s, and became chairman and CEO in 1999. Krupa reported to Creighton, and Creighton in turn allowed Krupa a great deal of authority and discretion. In 2003, Creighton approved a Jones & Brown loan of $135,000 to Krupa based on Krupa's plea that his daughter had been involved in a "very serious" car accident for which he had no medical insurance. As a result, he claimed, he was facing sizable legal and medical bills that

might drive him into bankruptcy.

Creighton didn't specifically advise other directors of the loan, although some of them later became aware of it. Jones & Brown had made loans to high-level employees in the past. Creighton later testified that the loan to Krupa had been a mistake and acknowledged that, in hindsight, his supervision of Krupa had been negligent. Creighton also testified that Jones & Brown had unwritten policies forbidding personal use of company time and property, but acknowledged that those policies were unenforced because of the trust and confidence he had placed in Krupa.

At that point, no one at Jones & Brown was aware of Krupa's gambling problem.

In 2004, after Krupa had failed to return the third investment, Zahl visited Jones & Brown's offices to see Creighton, explaining the terms that Krupa had represented. Creighton then met with Krupa who, after an initial denial, admitted that he had spent both Zahl's investment money and the Jones & Brown loan on gambling.

Zahl filed suit against Jones & Brown, Creighton and other directors, alleging breach of contract, fraud and negligence with respect to Krupa's hiring, retention and supervision. Jones & Brown was later dropped from the lawsuit.

The trial court granted summary judgment in favor of the directors, which the Appellate Court affirmed. As for the breach of contract claim, the court noted the general rule that corporate officers are not liable for corporate obligations. It then analyzed and synthesized two competing lines of Illinois decisions, one of which holds directors liable for active participation (or willful inaction) with respect to wrongdoing, and another which imposes liability for mere negligence.

As for the active participation claim, the court concluded that Zahl presented no evidence that the directors knowingly or recklessly participated, whether actively or passively, in Krupa's misconduct.

Referring to the more difficult inquiry of whether the defendants were negligent at all, the court similarly concluded that there was no triable issue of fact that the defendants were indeed negligent with respect to Krupa. Noting that Zahl presented no evidence that Krupa had a gambling habit or tendency to deceive when Jones & Brown hired him, the court also concluded that there was no question of negligent hiring.

As for Zahl's argument that the directors turned a blind eye to Krupa's "excessive and unusual" borrowing, the court rejected the argument out-of-hand, noting Jones & Brown's custom of making loans to employees and the apparent legitimacy of Krupa's loan request. With regards to Creighton's admissions of negligent supervision, the court noted that Creighton himself was applying a hindsight standard. And as for the plaintiff's assertion that Krupa had been given too much autonomy, the court noted that directors "of necessity" assign the immediate management of a particular business to subordinate officers, and found it unlikely that the most intrusive of measures could have thwarted Krupa's machinations.

Rejecting Zahl's efforts to argue backward from consequences, the court affirmed the legally recognized standard of assessing what was known and foreseeable to the directors at the time of their conduct, and concluded that their conduct was reasonable as a matter of law. The court concluded by noting that Illinois law will "treat directors with more leniency with respect to a single isolated act of fraud on the part of a

subordinate officer or agent, than when the practice appears to have been so habitually and openly committed as to have been easily detected upon proper supervision."

As for Zahl, we can easily see how she was duped, as well as what she might have done differently in order to protect herself from the fraud. While she was naturally hesitant (because of her relationship with Krupa) to ask for more formal documentation, as well as confirmation of the arrangement with other Jones & Brown representatives, that's precisely what she ought to have done.

The lesson is this: If the directors had been aware of their co-director's gambling habit or his tendency to take investments, and had they known he was using any company property or company time to conduct any type of separate business, we can easily imagine a different analysis, if not an entirely different outcome. The need for vigilance is all too clear. As a corporate director, you will be known and potentially responsible for the company you keep.

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