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Corporate and Securities Law Update

California Supreme Court Decision Reduces Risk of Personal Unpaid Wage Liability for Officers and Directors of Troubled Companies

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In an important victory for California officers and directors, on August 11, 2005, the California Supreme Court held such individuals are not liable to employees for unpaid wages. In recent years, officers and directors of “troubled” companies have faced potential risk of individual liability for unpaid wages if a company runs out of cash. While the facts of the case involved claims against officers and directors alleging that they intentionally misclassified plaintiff to avoid overtime pay, the California Supreme Court’s finding in *Reynolds v. Bement* that the individual defendants were not “employers” under the Labor Code should also apply to limit officers’ and directors’ potential liability under California law for unpaid wages in situations where a troubled company is unable to make payroll due to lack of cash.

The California Labor Code provides employees with a private right of action to recover unpaid wages against their employer. However, the relevant provisions of the Labor Code do not define who is an “employer.” Plaintiffs argued that the Court should adopt the definition of “employer” in wage orders set forth by the Industrial Welfare Commission (IWC), which defines the term to include an individual who “exercises control over the wages, hours, or working conditions of any person.” In administrative proceedings, the California Labor Commissioner applies this definition of “employer” when deciding whom to prosecute for violations of wage and hour laws. The Court, however, rejected the IWC’s definition of “employer,” concluding that the California Legislature did not intend to adopt the IWC’s definition to expose corporate agents to personal civil liability in court under the Labor Code. The Court therefore held that plaintiffs may not sue the individual defendants for unpaid wages.

Although the *Reynolds* decision is a significant victory for boards, employers should be mindful that individual directors, officers and other supervisory-level employees may still be liable for civil penalties and for unpaid wages through claims brought under federal law, or through administrative actions before the California Labor Commissioner. In particular, the federal Fair Labor Standards Act (FLSA), unlike the California Labor Code, defines “employer” to include individuals. (In a concurring opinion, Judge Carlos Moreno urged the California Legislature to adopt the FLSA’s definition of “employer”). The FLSA, however, presents certain disadvantages to employees: a case brought under the FLSA is subject to removal to federal court, and the FLSA’s substantive law generally is not as favorable to employees as California wage and hour law. Therefore, plaintiffs will now face a difficult choice in determining whether to proceed under state or federal law. In addition, although the Labor Commissioner may apply a broader definition of “employer,” employers and their agents can appeal unfavorable Labor Commissioner rulings to California courts, which may very well apply the *Reynolds* holding to the dispute.

Bottom line, while the case does not completely insulate officers and directors of California companies from individual claims for wage claims, it is nevertheless a very promising development for employers and their officers and directors.

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