THARPE & HOWELL

BUSINESS LAW NEWSLETTER

This Newsletter is brought to you by Tharpe and Howell's Commercial Litigation Practices Group. For more information, contact Robert Freedman, chair of the Group, or David Binder, partner in charge of the Employment Practices Team at rfreedman@tharpe-howell.com; dbinder@tharpe-howell.com; or phone number (818) 205-9955.

PERSONAL GUARANTEE INSURANCE CAN PROTECT BUSINESS OWNERS

Business owners are often faced with the dilemma of providing a personal guarantee to secure a business loan or financing. This can be very risky since many smaller companies may not have the assets and/or insurance needed to cover the guaranteed liability thus putting the owners' personal assets at risk for covering certain losses.

Tharpe & Howell is pleased to announce publication of the *California Business Law Report (CBLR)*. This is an exciting new online forum which provides regular updates on significant business and legal issues that impact our clients, and the California business community in general. It is designed to addresses the rapidly increasing convergence of business and law. We invite you to join us at: www.commercialcounselor.com.

The primary risk management tool in this area is to establish a separate corporate entity such as a corporation or LLC, and to maintain its integrity by keeping the entity separate and distinct from the individual guaranteeing the obligation, including avoiding co-mingling of expenses and assets. However, should a loss exceed the ability of the corporate entity to respond, then the personal guarantor will still be personally at risk for making up the deficit.

Now, small to medium sized business owners have a new form of protection against losing personal assets when a personal guarantee is required. Insurance companies have begun offering *personal guarantee insurance*, a policy which, according to *Smart Business*, is "designed to pay up to 70% of a deficiency judgment in the event of a loan default." With this insurance product, business owners guaranteeing their company's obligations can feel more confident moving forward in borrowing capital for expansion, or to enter into a business lease or finance an equipment purchase where before they may have hesitated out of concern that default would fall on their personal assets.

BUSINESS FORMATIONS MAY HELP ISOLATE LIABILITY, BUT ONLY IF MAINTAINED

A recent Arizona decision reminds businesses which have layered corporations that they need to maintain each of these entities as if they were stand-alone companies if they want to isolate liability.

In *Activator Methods v. Future Health*, Activator and Future entered into a marketing agreement. When Future failed to pay an obligation to Activator, Activator terminated the agreement and ceased doing business. The owners of Future incorporated another entity in Delaware, Future-Delaware, and resumed its operation. When Activator brought suit in Arizona against Future, Future-Delaware, and the principals of the companies, the principals of Future and Future-Delaware sought to dismiss the action claiming a failure to plead facts establishing that Future and Future-Delaware were the alter egos of its principals.

The Court held that since the principals of Future and Future Delaware used corporate funds as if they were their own, and , since corporate formalities were disregarded, there was sufficient evidence to allow the case to proceed. The "piercing the corporate veil" principles apply where one corporation owns another. When this occurs, corporate protections are lost and owners become personally liable for the actions of the corporation.

Generally, the courts look at various elements to determine if the corporate protections should be set aside, examples of which include:

* Commingling of funds;
* Using corporate money to pay for personal expenses;
* Failure to distinguish corporate affairs from its principals' personal affairs;
* Inadequate capitalization; and
* Disregard of corporate formalities and segregation of corporate records.

CYBER SECURITY ACT OF 2012

If your business owns or operates "critical infrastructure" in the United States, the proposed Cybersecurity Act of 2012 currently being discussed in the US Senate needs to be on your radar.

In the bill, critical infrastructure is defined as "systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of such systems and assets would have a debilitating impact on security, national economic security, or national public health or safety." This definition in the Act comes from the USA PATRIOT Act. While it currently remains unclear precisely which business owners will fall within the definition of owning or operating "critical infrastructure," the list could be broad and include many sectors, like financial, energy, food, medical, healthcare, etc. Moreover, the Act directs the Secretary of Homeland Security to consult with such businesses and other government and private entities for the purpose of:

1. Conducting cyber risk assessments of critical infrastructure, beginning with sectors that face the greatest immediate risk;
2. Establishing procedures to designate critical infrastructure;
3. Identifying or developing risk-based cybersecurity performance requirements; and
4. Implementing cyber response and restoration plans.

Bottom line, the Act provides Homeland Security broad authority to define and regulate company requirements in protecting "covered critical infrastructure."

TENANT WAIVERS: ARE THEY ENFORCEABLE?

In California, most residential rental provisions purporting to waive the landlord's liability for injuries or damages caused by the landlord's own negligence are unenforceable as a matter of law.
[See *California Civil Code* Section 1953(a)(5).]

However, this tenant protection may not extend to incidents relating to landlord provided amenities such as exercise facilities as was recently decided in *Lewis Operating Corporation, et al. v. The Superior Court of Riverside County*.

In *Lewis*, tenant Costahaude sued his landlord after being injured in a landlord operated exercise facility. In response, the landlord requested that the court dismiss the case based on a provision in Mr. Costahaude's rental agreement which stated that the landlord was not liable for any harm resulting from use of the exercise facilities - even if the harm was caused by the landlord's own negligence. Mr. Costahaude argued that the release and waiver contained in the rental agreement were against public policy and unenforceable under *California Civil Code* Section 1953(a)(5) – with which the Trial Court agreed and denied the landlord's request. The landlord appealed.

In its appeal, the landlord argued the exercise facility is an amenity not protected under the *California Civil Code*. The Court of Appeal then looked at whether such waivers favoring landlords are to be applied differently dependent upon whether they relate to a basic/essential common areas (parking area, lawn, walkway, or corridor); as opposed to the tenant's use of a landlord provided *amenity* (such as an exercise facility). The Appeals Court held that where a landlord chooses to provide an amenity such as an exercise facility, there is no reason why the landlord cannot protect itself by requiring that the tenant, as a condition of use of the amenity, execute a waiver and liability release. Accordingly, the Trial Court was ordered to vacate its previous ruling in favoring the tenant and enter a new order granting the landlord's dismissal request.

A Special Relationship Can Lead To Vicarious Liability

A recent decision by the Supreme Court of California brings home the importance of exercising reasonable care in the supervision, hiring, and retention of employees, especially when a *special relationship* exists between the organization and the individuals it serves.

Public schools are perfect examples of settings where this special relationship exists, i.e. the relationship between the school and its students. Hospitals and rehabilitation facilities also appear to have a special relationship with those they serve. But exactly how far the concept of a special relationship extends is difficult to say and will likely be determined on a case by case basis, subject to an intensive fact analysis.

Does a special relationship exist between a corporation, its employees, its customers, or even members of the public in general, who may be injured by actions of company employees? Can an injured employee, customer, or member of the public state a valid legal claim by alleging that the damage they suffered was caused by the company' negligence in the supervision, hiring, or retention of the employee responsible for such damage?

A recent California Supreme Court decision involved a student who sued the school for negligent supervision of a guidance counselor who he alleged sexually molested him, arguing the school knew, or should have known of the counselor's "propensities," and thereafter "failed to use reasonable care in investigating her." The court noted "school districts and their employees have never been considered insurers of the physical safety of students," but nonetheless reversed the lower courts.

In *C.A. v. William S. Hart Union High School* [53Cal. 4th 861 (2012)], the Court held that a public school district may be vicariously liable for the negligence of administrators or supervisors in hiring and retaining a school employee who molests a student.

It remains to be seen in the *Hart* case whether the student can prove his allegations at trial, but the potential for lawsuits based on vicarious liability now exists on a broader scale when a special relationship can be shown. As such, the *Hart* decision has important implications for insurance policies covering employment practices, and means all California businesses, as well as public entities, must be diligent in their hiring/supervision, using effective background checks, especially where there is a "special relationship" between the business or public entity and those they serve.

A COMPANY CAN BE LIABLE FOR CYBER BULLYING

Employers now face potential liability for employee harassment of fellow workers, even if the harassing activity is conducted outside the work place. That's what a California appellate court decided in February 2012, when harassment, in the form of cyber-bullying via postings on a personal blog, was considered an extension of workplace harassment, and the employer knew it was occurring. Under such circumstances, the employer had a duty to take remedial action, which it failed to do in *Espinoza vs. County of Orange*.

Espinoza involved a juvenile corrections officer with the Orange County Probation Department, born with no fingers or thumb on his right hand. A blog started outside of work by others in the Department included numerous postings that referred to Espinoza's "claw," offering $100 to anyone who could get a photo of his hand, and contained unflattering comments by several others.

The *Espinoza* court noted that Section 12941(j)(1) of the Government Code states: "Harassment of an employee . . . by an employee, other than an agent or supervisor, shall be unlawful if the entity, or its agents or supervisors, knows or should have known of this conduct and fails to take immediate and appropriate corrective action." The court reasoned that liability under the statute is premised on failing to take remedial action, not where and when the harassment occurred. The fact that certain harassing activity occurred outside the workplace was less relevant than the fact that the employer knew of the activity and failed to take action, especially since employees also used workplace computers to access the personal blog and the activity was seen as an extension of harassment occurring in the workplace.

While employers have no legal duty to monitor private communications of their employees, a recent article notes the General Counsel of the National Labor Relations Board, in a January 2012 report to regional staff, "approved policies that prohibited the use of social media to post or display comments about coworkers or supervisors or the Employer that are vulgar, obscene, threatening, intimidating, harassing, or a violation of the Employer's workplace policies against discrimination, harassment, or hostility on account of age, race, religion, sex, ethnicity, nationality, disability, or other protected class, status, or characteristic." The *Espinoza* case, and NLRB policy, have caused at least one commentator to suggest that the emerging rule is "once an employer becomes aware of off-duty harassment of one employee by another, the employer has a duty to stop work place related harassment, no matter whether it is taking place at the workplace, off-site, or online."

Tharpe & Howell has been part of the California, Arizona and Nevada business communities for more than 35 years, providing clients with experience, judgment, and technical skills. We are committed to delivering and maintaining excellent client service and case personalized attention, and to be an integral member of each client's team. For further inquiry about any of the articles discussed, please contact Mr. Freedman direct at (818) 205-9955; Email: rfreedman@tharpehowell.com