Articles

The Lurking Menance of Duty of Loyalty Claims

V. John Ella
(jella@mansfieldtanick.com)
Mansfield, Tanick & Cohen, P.A.
1700 U. S. Bank Plaza South
Minneapolis, MN 55402
Tel: 800-401-6194
FAX: 612.339.3161

I. The Law of Duty of Loyalty in Minnesota

Introduction

Duty of loyalty issues arise when an employee of a business, while employed, communicates with customers of that business about the possibility of the employee leaving and taking that customer's business with him or her. Often, by the time the employee sees an attorney it is too late to undo what has occurred and the employee may be barred indefinitely from seeking business from those customers. If a client does approach an attorney the possibility of starting his or her own business, therefore, it is critical that the practitioner raise this danger immediately in order to keep the employee's options open. If an employee has a close relationship with one or more customers and is not subject to a noncompete, he or she is usually able to depart employment and then successfully, and legally, solicit those customers for the new business. Unfortunately, many budding entrepreneurs are unaware of the lurking menace of the common law obligation of duty of loyalty and find themselves in a box, having burned their bridges at the old employer and being barred from soliciting their client base.

Two points are important to keep in mind about duty of loyalty: First, the obligation arises whether or not there is a written agreement, such as a noncompete, and regardless of what level or title the employee held at the company. Second, timing and sequence of events are crucial. If the departing employee calls a customer 15 minutes before quitting, he or she faces a big problem. If he or she quits and then calls a customer 15 minutes later, he or she is in the clear. This appears arbitrary, but it is the law.

B. Legal Standard

In Minnesota, the seminal case on duty of loyalty is *Rehabilitation Specialists, Inc. v. Koering*, 404 N.W.2d 301, 304 (Minn. Ct. App. 1987). In that case, the Court of Appeals held that, "**an employee's duty of loyalty prohibits her from soliciting the employer's customers for herself, or from otherwise competing with her employer, while she is employed.**" *Id.* at 304. (Emphasis added) *See also, Sanitary Farm Dairies, Inc. v. Wolf*, 261 Minn. 166, 112 N.W.2d 42 (1961). In *Rehabilitation Specialists*, an employee of a firm providing physical therapy and other services to health care facilities left to start her own business. Before doing so she informed a major customer of her intention, and the customer told her that there would probably be some new contracting opportunities. Then-Hennepin County District Court Judge Jonathon Lebedoff dismissed the claim because the employee had not actually "solicited" the customer. The appellate court reversed, noting that "even if the characterization of her conduct as passive were accurate, it would not necessarily shield her from liability." *Id.* at 305 (citing *Community Counseling Service, Inc. v. Reilly*, 317 F.2d 239, 244 (4th Cir. 1963) for the proposition that "if prospective customers undertake the opening of negotiations which the employee could not initiate, he must decline to participate in them.") This holding must serve as a warning to employees thinking of leaving who should probably place their hands over their ears if a major customer starts dropping hints that the employee should leave and start his own business, but by then it may already be too late.

The second most important statement from the *Rehabilitation Specialists* case is the corollary statement that, "Employees who wish to change jobs or start their own businesses, however, should not be unduly hindered from doing so. An employee has the right, therefore, while still employed, to **prepare** to enter into competition with her employer." *Rehabilitation Specialists, Inc.*, 404 N.W.2d at 304. *See also Sanitary Farm Dairies*, 261 Minn. at 175-76, 112 N.W.2d at 48-49. This means that an employee may take certain steps prior to leaving employment other than contacting or soliciting customers. For example, an employee may presumably form a corporation, secure lending, or enter into a lease without running afoul of the law, especially if the employee does so on his or her own time and without the use of

company resources or connections.

The most famous phrase used to describe these situations is taken from *Sanitary Farm Dairies* wherein the court stated that, "While it is true that an employee may take steps to insure continuity in his livelihood in anticipation of resigning his position, **he cannot feather his own nest** at the expense of his employer while he is still on the payroll." *Id.* at 49 (emphasis added).

C. Legal Background

An implied condition in every employment contract is the employee's duty of honesty and faithfulness to the employer. *Hlubeck v. Beeler*, 214 Minn. 484, 489, 9 N.W.2d 252, 254 (1943). Minnesota Courts recognize at least three claims upon which relief can be granted based on a violation of an employee's fiduciary duty to their employers: "(1) soliciting business of the employer prior to leaving the employment relationship, (2) disclosing or misappropriating information that the employer has treated as a secret, and (3) engaging in serious misconduct such as embezzlement or referring customers to a competitor." *Bellboy Import Corporation v. Baghart*, 2004 WL 2711052 (Minn. Ct. App. 2004).

The duty of loyalty, which is a subset of unfair competition, has been characterized as "a general category of torts recognized by Minnesota courts to protect commercial interests." *Midwest Sports Marketing, Inc. v. Hillerich & Bradsby of Canada, Ltd.*, 552 N.W.2d 254 (Minn.App.1996), *rev. denied* (Minn. Sept. 20, 1996)(citing *Rehabilitation Specialists*, 404 N.W.2d at 305). The duties of loyalty and unfair competition do not necessarily have specific elements. *Rehabilitation Specialists*, 404 N.W.2d at 305; *see also Prosser & Keeton on Torts* § 130, at 1015 (5th ed. 1984); Restatement, Third, Unfair Competition § 1 and comments (1995). However, employees still retain a "common law duty not to 'wrongfully use confidential information or trade secrets obtained from an employer." *Northwest Airlines v. American Airlines*, 853 F. Supp 1110, 1117-18 (D. Minn. 1994) (quoting *Jostens Inc. v. National Computer Sys. Inc.*, 318 N.W.2d 691, 702 (Minn. 1982)).

The employee's duty of loyalty precludes employees from soliciting a former or current employer's customers prior to resignation and from failing to give sufficient notice of intention to resign. *See Loxtercamp, Inc. v. Belgrade Cooperative Association*, 368 N.W.2d 299, 301 (Minn. Ct. App. 1985), *Rehabilitation Specialists, Inc.*, 404 N.W.2d at 305-06. However, "[t]here is no precise line between acts by an employee which constitute prohibited 'solicitation' and acts which constitute permissible 'preparation.'" *Rehabilitation Specialists, Inc.*, 404 N.W.2d at 305. "Because of the competing interests, the actionable wrong is a matter of degree." *Id* . "Whether an employee's actions constituted a breach of her duty of loyalty is a question of fact to be determined based on all the circumstances of the case." *Id. See also Sanitary Farm Dairies,* 261 Minn. at 175, 112 N.W.2d at 48. "What is required is a balancing of the employer's legitimate interest in having its business advanced by an employee, and the employee's legitimate interest in bettering him or herself in a new business and providing for his or her continuing livelihood." *Signergy Sign Group, Inc. v. Adam*, 2004 WL 2711312, at *1 (Minn. Ct. App. 2004). *See also Sanitary Farm Dairies, Inc. v. Wolf,* 112 N.W.2d 42, 47-48 (Minn. 1961). It is clear, however, that an employee breaches his fiduciary duty to an employer by disclosing confidential information and by competing with his employer. *See Eaton Corp. v. Giere,* 971 F.2d 136, 141 (8th Cir. 1992).

Eaton involved an employee of a large manufacturing corporation who left to attempt to sell a transaxle that he was developing to Toro, a Minnesota corporation that makes lawn mowers. The employee in *Eaton* was found to have violated both his common law duty of confidentiality and his duty of loyalty by approaching Toro, corresponding with Toro, and meeting with representatives of Toro while he was employed by Eaton.

II. Remedies

What are the possible legal remedies for breach of duty of loyalty? This issue creates a surprising amount of confusion.

A. Equitable or Injunctive Relief

At least one Minnesota court has granted injunctive relief for an alleged breach of duty of loyalty. *Workers Compensation Recovery, Inc. v. Marvin*, 2004 WL 1244404 (Minn. Ct. App. 2004). In *Marvin*, the employee (Marvin) left to start her own competing business in the area of worker's compensation loss prevention. Before leaving Marvin had a conversation with one of her employer's most important clients, BHS, during which discussion they talked only about the fact that she would be leaving and starting her own business. The old employer sought and received a temporary restraining order ("TRO") and subsequent temporary injunction enjoining Marvin from conducting business with BHS for six months. *Id.* The injunctive relief was upheld by the Court of Appeals. *Id.* The *Marvin* decision, although unpublished, is a useful template for businesses facing the threat of a departing employee and stands for the proposition that injunctive relief is appropriate and that six months is a reasonable time frame. It is worth noting that proper use of a TRO and Temporary Injunction may moot confusion over the proper measurement of actual damages as discussed below.

B. Restitution.

There are currently no model jury instructions in on damages for breach of duty of loyalty or breach of fiduciary duty. In one recent case, the Eighth Circuit Court of Appeals (interpreting Minnesota law) stated as follows:

An employee who breaches a noncomepetition or nondisclosure covenant can be required to account for his profits. Cherne Indus. v. Inc. v. Grounds & Assoc., Inc. 278 N.W.2d 81, 94-95 (Minn. 1979). The remedy for breach of duty of loyalty is also restitutionary. See Miller v. Miller, 301 Minn. 207, 222 N.W.2d 71, 78 (remedy for breach of fiduciary duty is constructive trust).

Storage Technology Corporation v. Cisco Systems, 395 F.3d 921 (8th Cir. 2005). In *Storage Technology*, the Court upheld dismissal of a duty of loyalty claim where the plaintiff failed to substantiate any amount of damages or restitution. This case suggests that the measure of damages is the same or similar to a case involving breach of a noncompete, which at least in some cases is measured by the lost profits of the injured party[1], but at the same time the case suggests that the measurement is an accounting or disgorgement of the *offender's* profits ("can be required to account for *his* profits.") The key in *Storage Technology*, and the downfall of the plaintiff, was that the actual harm or damages must be proven and cannot be speculative.

In other words, in order to recover on a breach of loyalty claim, an employer must do more than identify acts of improper solicitation of customers. It must also show that the actions of the employee proximately caused an identifiable loss. *See Graphic Directions*, Inc. *v. Bush* 862 P.2d 1020, 1024 (Colo. App. 1993); *Marshfield Mach. Corp. v. Martin*, 246 Wis. 2d 668, 630 N.W.2d 275 (Wisc. Ct. App. 2001) ("to meet the burden of production with respect to causation, plaintiffs must produce some credible evidence that [employees'] alleged breach of fiduciary duty was more probably than not a substantial factor in causing their claimed damages"); *Loundes Products, Inc. v. Brower*, 259 S.C. 322, 191 S.E.2d 761 (S.C. 1972) (an employer who has sustained its burden of proving breach of an employee's duty of loyalty not to solicit customers is "entitled to collect all damages proximately resulting from the wrongful conduct"). In *Graphic Directions*, the Colorado Court of Appeals reversed the Colorado trial court, and held that although evidence at trial "was sufficient to establish the existence and the breach of a fiduciary duty," the "evidence of damages was insufficient to permit the claim to go to the jury" as a matter of law. *Id.* at 1024.

In one case in which the author was involved prior to *Storage Technology*, the former employer attempted to argue that "disgorgement" of all income earned by the departing employee and his new business was the proper remedy since the claim arguably involved a species of breach of fiduciary duty. The case settled on the eve of trial without a decision by the trial court on this issue, but at the time little or no legal support existed for this theory. In *Talcott Communications Corp. v. Coles*, 1993 U.S. Dist. LEXIS 1983 (N.D. Ill. Feb. 25, 1983), an action based on an alleged breach of duty of loyalty by the employee, a federal district court held that equitable relief in the form of disgorgement is only available when proof of actual damages is shown to be so complicated as to be impossible. Specifically, it stated as follows:

[C]ourts have broad discretion to refuse to award such a remedy to a party who has an adequate remedy at law. [Disgorgement] is proper only when accounts between the parties are so complicated that a special master or jury cannot adequately assess damages. The Supreme Court has set forth the standards for granting an equitable accounting: "The necessary prerequisite to the right to maintain a suit for an equitable accounting, like all other equitable remedies, is . . . the absence of an adequate remedy at law. Consequently, in order to maintain such a suit on a cause of action cognizable at law . . . the plaintiff must be able to show that the 'accounts between the parties' are of such a 'complicated nature' that only a court of equity can satisfactorily unravel them." [cite omitted] In this case, Talcott fails to show that the accounts are so complicated as to be beyond the comprehension of the fact finder. *Id.* at *5 (emphasis added).

C. Lost Profits.

One means of demonstrating actual proximate injury is to measure lost profits caused by the breach. In *ABC Trans Nat Transport, Inc. v. Aeronautics Forwarders, Inc.*, 90 Ill. App.3d 817, 413 N.E.2d 1299, 1312 (1980), the Illinois appellate court affirmed the trial court's award to a plaintiff employer of lost profits proximately caused by the defendant's fiduciary breaches, as proven through expert testimony. *See also E.J. McKernan Co. v. Gregory*, 252 Ill. App. 3d 514, 623 N.E.2d 981 (1993) (affirming award of lost profits for breach of employee's fiduciary duty of loyalty and usurpation of corporate opportunity, proven through expert testimony). See also *Graphic Directions, Inc. v. Bush*, 862 P.2d 1020 (Colo. App. 1993); *Eaves v. Hillard*, 1988 Tenn. App. LEXIS 270 (May 18, 1988)(damages based on proven loss of business, that plaintiff could have handled the additional business without additional expenses, and proven gross profits that plaintiff would have received, but for employee's breach); *Medrehab of Wisconsin, Inc. v. Johnson*, 218 Wis.2d 163, 578 N.W.2d 208 (Wis. App. 1998) (damages awarded upon expert testimony as to lost profits resulting from employee disloyalty).

D. Forfeiture of Wages.

There exists a line of cases standing for the proposition that the proper remedy for breach of fiduciary duty by an employee is forfeiture of

payments made to the employee during which time he or she was engaged in the breach of loyalty. One treatise specifically states that, in the event that an employee breaches his or her duty of loyalty, "[a]n employer may recover damages or withhold the payment of wages in the event of a breach of this duty." 17 Minn. Prac., *Employment Law & Practice, Employer Claims: Noncompete Clauses, Trade Secrets and The Duty of Loyalty*, § 13.31 (2d ed.).

If an employee is found to have breached his or her duty of loyalty, the employee is deemed to have never effectively earned the wages that he or she is claiming. *Peterson v. Mayer*, 46 Minn. 468, 49 N.W. 245 (1891). *See also Hlubeck*, 214 Minn. at 486, 9 N.W.2d at 253 (court will examine only conduct that occurred during that portion of employment contract for which employee is seeking wages). Because of the employee's breach of the duty of loyalty, he or she did not satisfy the terms and conditions of the employment contract. *See Stiff v. Associated Sewing Supply Co.*, 436 N.W.2d 777, 780 (Minn. 1989). Therefore, an employee in breach of the duty of loyalty never effectively earned the wages that he was claiming. But an employer may still be required to show that it has suffered damage as a result of a breach of the duty of loyalty. *E.g. Storage Technology Corp. v. Cisco Systems, Inc.*, 395 F.3d 921 (8th Cir. 2005)

In Minnesota, employers are prohibited from making deductions from an employee's wages for theft, loss or indebtedness without the employee's prior written consent. Minn. Stat. § 181.79 (1993). Arguably, however, this statutory provision does not preclude forfeiture of wages under the implied common law duty of loyalty. The statute is inapplicable because the employee, having breached the duty of loyalty, failed to live up to his or her end of the bargain and did not effectively earn any wages. *See Stiff*, 436 N.W.2d at 780.

It should also be noted that an employer can withhold certain benefits and bonuses if the duty of loyalty is breached. In *Brozo v. Oracle Corp.*, management exercised its rights under an employment contract when it "decided that [the employee] deserved no incentive bonus in a year in which *he breached his duty of loyalty by soliciting employees and customers to join him in a competing venture.*" 324 F.3d 661, 665 (8th Cir. 2003). As the 8th Circuit stated, "[t]hat type of employee misconduct will be penalized almost anywhere." *Id.*

III. Unresolved Issues and Questions for Discussion

A. Is there a Duty of Loyalty owed by a Minority Shareholder in a Corporation after termination of employment?

The question often arises whether an employee who also holds shares in a closely-held corporation is free to compete once he leaves employment but before he has his share ownership redeemed. One means of resolving this is to have the employee/shareholder tender his shares or give them up (without payment) in order to be free and clear, but this means leaving behind the value of those shares. On recent decision reaches the surprising conclusion that a minority shareholder, at least one who does not have voting stock, was never a director and resigned as an officer does not owe a fiduciary duty to the corporation. *See Advanced Communication Design, Inc. v. Follett*, 601 N.W.2d 707 (Minn. Ct. App. 2000), *affirmed*, 615 N.W.2d 285 (Minn. 2000). But beware of relying on this narrow holding: non-voting stock is relatively rare, and shareholders are generally charged with some minimal duty to the corporation.

B. Does Duty of Loyalty Extend to Referral Sources?

No reported cases in Minnesota have addressed whether an employee who discusses plans to compete with a referral source who essentially controls the flow of customers to the employer (a situation faced by the author in one case) could be liable for a breach of duty of loyalty claim. Arguably courts might look at the practical impact of the discussion and the relationship of the parties, but *Rehabilitation Specialists* and its progeny seem to be limited to "customers" on their face. Similar questions arise with regard to vendor relationships, although the Court in *Signergy Sign Group, Inc. v. Adam*, 2004 WL 2711312 (Min. Ct. App. 2004) seemed to be unconcerned about contacts to "two suppliers of equipment and material" by the departing employees of a sign company.

C. Does a Duty of Loyalty Claim arise where an Employee leaves to join a Customer as an "in-house" employee, the effect of which is to divert business from the previous Employer? What if the Employee leaves to become an independent contractor? What if the Employee becomes a part owner in the Customer's business?

It is not uncommon for a major customer or client to ask a key employee of a vendor tojoin it in an "in-house" position. This can have the effect of limiting or eliminating the flow of work to the former employer and could be seen as a breach of duty of loyalty. Where the employee does not start his own business, however, and does not have a noncompete, it would not likely be viewed as such by the courts. The line gets much fuzzier if the customer provides equity in the form of stock. In that case the employee is benefiting from more than a job. The case is arguably more clear cut where the employee becomes an independent contractor of the customer and arranged for that relationship before leaving employment. Few courts have explored this boundary region of the law, however.

IV. Conclusion.

Employees even considering leaving their employment to compete against their employer should be very wary of the harsh consequences of the lurking menace of the Duty of Loyalty.

[1] At least some courts have held that in the case of a breach of a noncompete the measure of damages is plaintiff employer's loss, not defendant employee's gain. *Faust v. Parrott*, 270 N.W.2d 117, 120 (Minn. 1978) ("damages awarded for a breach of a [noncompetition agreement] are measured by the business loss suffered as a consequence of the breach"). *See also B&Y Metal Painting, Inc. v. Ball*, 279 N.W.2d 813, 816 (Minn. 1979).

Mansfield, Tanick & Cohen, P.A.
Attorneys at Law

1700 U.S. Bank Plaza South
220 South Sixth Street
Minneapolis, MN 55402

Phone: 800.401.6194
Fax: 612.339.3161