Faithless Servant Doctrine:

Employer's Right to Recover Compensation from Disloyal Employees

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I. Background

The Faithless Servant Doctrine is a common law doctrine which originated in New York State, under which employers may refuse to pay an employee for the time the employee was unfaithful to his or her duties. In applying the doctrine, courts have gone so far as to rule that employees must forfeit all compensation received after their first disloyal act. *See, e.g.*, *Phansalkar v. Andersen Weinroth & Co., L.P.*, 344 F.3d 184 (2d Cir. 2003) (applying New York law).

The original New York case which established the doctrine was *Murray v. Beard*, 102 N.Y. 505, 508 (1886). In *Murray*, an agent, a timber broker, was held to *uberrima fides* (the fiduciary standard of utmost good faith) in his dealings with his principal, a group of timber dealers. The court held that if the agent acted adversely to his principal in any transaction, or omitted to disclose any interest which would naturally influence his conduct in dealing with the subject of the employment, it would amount to such a fraud upon the principal as to forfeit the agent's right to compensation for services.

Thus, the central issue in nearly all faithless servant cases is the employee's fiduciary duties to his or her employer – particularly the duty of loyalty. This is important to keep in mind, as some jurisdictions have adopted the Faithless Servant Doctrine or some variation thereof, but couch their relevant case law in terms of an employee's fiduciary duties rather than specifically using the phrase "faithless servant".

II. Recent Cases Brought Under New York Law

The Faithless Servant Doctrine is still regularly applied in cases brought under New York law. *See, e.g.*, *Design Strategy, Inc. v. Davis*, 469 F.3d 284 (2d Cir. 2006) (applying New York law); *Phansalkar v. Andersen Weinroth & Co., L.P.*, 344 F.3d 184 (2d Cir. 2003) (applying New York law); *William Floyd Union Free Sch. Dist. v. Wright*, 61 A.D.3d 856, 2009 N.Y. App. Div. LEXIS 3067 (N.Y. App. Div. Apr. 21, 2009); *South Pierre Assocs. v. Meyers*, 12 Misc.3d 955 (Civ. Nt. N.Y. Cty. 2006).

III. Application Beyond New York

Many other jurisdictions have also considered the Faithless Servant Doctrine or some variation thereof, and have accepted or rejected it to varying extents.

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Jurisdictions which have adopted the doctrine include California (*J.C. Peacock, Inc. v. Hasko*, 16 Cal. Rptr. 518, 522-24 (Cal. Ct. App. 1961)); the District of Columbia (*Riggs Inv. Mgmt. Corp. v. Columbia Partners, L.L.C.*, 966 F. Supp. 1250, 1266 (D.D.C. 1997) (holding that "no compensation is owed an employee who has breached his duty of loyalty to his employer," and that the employee must return to his employer compensation he earned following the disloyal act)); Maryland (*Shipley v. Meadowbrook Club, Inc.*, 126 A.2d. 288, 291 (Md. 1956) (disloyal agents may be denied compensation, "particularly where there is a conflicting interest, concealment, or a willful and deliberate breach of his contract")); Georgia (*Vinson v. E.W. Buschman Co.*, 323 S.E.2d 204, 207 (Ga. App. 1984)); Illinois (*ABC Trans Nat. Transport v. Aeronautics Forwarders, Inc.*, 413 N.E.2d 1299, 1314-15 (Ill. App. 1980)); Missouri (*Zakibe v. Ahrens & McCarron, Inc.*, 28 S.W.3d 373, 385-86 (Mo. App. 2000) (collecting additional cases)); and Oregon (*Horton v. Whitehill*, 854 P.2d 977, 980 (Or. App. 1993)).

States which have adopted at least some aspect of the doctrine include Massachusetts (*Meehan v. Shaughnessy*, 535 N.E.2d 1255, 1266-67 (Mass. 1989); *Chelsea Indus. v. Gaffney*, 449 N.E.2d 320, 327 (Mass. 1983)); Delaware (*Triton Constr. Co., Inc. v. E. Shore Elec. Servs., Inc.*, 2009 Del. Ch. LEXIS 88 (Del. Ch. May 18, 2009); *Technicorp Int'l II, Inc. v. Johnston*, No. 15084, 2000 Del. Ch. LEXIS 81, *196, *199 (Del. Ch. May 31, 2000); *Citron v. Merritt-Chapman & Scott Corp.*, No. 3130, 1977 Del. Ch. LEXIS 183, *12 (Del. Ch. May 4, 1977)); Pennsylvania (*Fidelity Fund, Inc. v. Di Santo*, 500 A.2d 431, 439-40 (Pa. Super. Ct. 1985)); New Jersey (*Cameco, Inc. v. Gedicke*, 724 A.2d 783, 790-91 (N.J. 1999)); and Texas (*Burrow v. Arce*, 997 S.W.2d 229, 241-42 (Tex. 1999)).

States which have rejected the doctrine include Connecticut (*Dunsmore & Assocs., Ltd. v. D'Alessio*, 2000 Conn. Super. LEXIS 114 (Conn. Super. Ct. Jan. 6, 2000) (unpublished)); Florida (*Wallace v. Odham*, 579 So. 2d 171, 175 (Fla. Dist. Ct. App. 1991)); and Rhode Island (*Oken v. National Chain Co.*, 424 A.2d 234 (R.I. 1981).

In March of 2004, Mark Jacoby and Marisa Leto of Weil Gotshal in New York published an "employer update" on his firm's website, entitled *Disloyalty Doesn't Pay: New York's "Faithless Servant" Doctrine*, which covers in some detail various state court rulings on this issue, complete with case citations. While the update is somewhat dated, it still serves as a particularly useful starting point for researching the current state of the law on this topic outside New York. The update can be found here: http://www.weil.com/news/pubdetail.aspx?pub=8640.

IV. **Recent Developments in the Doctrine**

In *Astra USA, Inc. v. Bildman*, 914 N.E.2d 36 (Mass. 2009), the court, applying New York law, held that a CEO fired for sexual harassment and misappropriation of company funds had to relinquish $7 million in salary and bonuses paid to him by the former employer. The court cited *Feiger v. Iral Jewelry, Ltd.*, 363 N.E.2d 350 (N.Y. 1977) for the proposition that "[o]ne who owes a duty of fidelity to a principal and who is faithless in the performance of his services is generally disentitled to recover his compensation, whether commissions or salary . . . Nor does it make any difference that the services were beneficial to the principal, or that the principal

suffered no provable damage as a result of the breach of fidelity by the agent." The court went on to state that "[h]arshness of the remedy [under the doctrine] is precisely the point."

In *Phansalkar v. Andersen Weinroth & Co.*, 344 F.3d 184 (2d Cir. 2003), the Second Circuit reversed S.D.N.Y. Judge Shira Scheindlin and held that the disloyal employee had to disgorge all compensation received from the date of his first disloyal act. In so holding, the court did not extend its prior holdings in *Musico v. Champion Credit Corp.*, 764 F.2d 102 (2d Cir. 1985) and *Sequa Corp. v. GBJ Corp.*, 156 F.3d 136 (2d Cir. 1998), in which the court had held that disloyal employees did not need to disgorge compensation received for transactions in which the employees had been loyal.

V. Choice of Law Issues

Choice of law issues often arise in faithless servant cases where the purportedly disloyal employee works in one state, but the employer is incorporated in and/or has its primary place of business in another state. Similar problems may also arise in cases involving employees whose job duties require them to travel a great deal. Since jurisdictions vary as to whether, or the extent to which, they accept the Faithless Servant Doctrine, these choice of law issues can potentially be dispositive to the outcome of the case.

In New York, the birthplace of the Faithless Servant doctrine, such choice of law issues are often resolved by applying what has been called the "internal affairs doctrine." Under this doctrine, issues arising from the fiduciary duty an employee owes to his employer (typically the central issue in faithless servant cases) are considered to be a part of the company's "internal affairs"; and conflict of law issues concerning a company's internal affairs are determined according to the law of the employer's state of incorporation. *See, e.g., BBS Norwalk One, Inc. v. Raccolta, Inc.*, 60 F. Supp. 2d 123, 129 (S.D.N.Y. 1999); *Geffner v. Linear Rotary Bearings, Inc.*, 936 F. Supp. 1150, 1184 (E.D.N.Y. 1996).

Thus, as a practical matter, application of the internal affairs doctrine would mean that many of these cases involving a choice of law question would be governed by Delaware law. And, as indicated above, Delaware has adopted a variation of the Faithless Servant Doctrine. *See Triton Constr. Co., Inc. v. E. Shore Elec. Servs., Inc.*, 2009 Del. Ch. LEXIS 88 (Del. Ch. May 18, 2009); *Technicorp Int'l II, Inc. v. Johnston*, No. 15084, 2000 Del. Ch. LEXIS 81, *196, *199 (Del. Ch. May 31, 2000); *Citron v. Merritt-Chapman & Scott Corp.*, No. 3130, 1977 Del. Ch. LEXIS 183, *12 (Del. Ch. May 4, 1977).

However, even in New York, the internal affairs doctrine is not automatically applied in all such cases. Instead, traditional choice of law principles are ordinarily considered in order to determine which state has a paramount interest in adjudicating the specific issue in dispute. *See, e.g., Koury v. Xcellence, Inc.*, 649 F. Supp. 2d 127 (S.D.N.Y. 2009) (*citing Caudle v. Towers, Perrin, Forster, & Crosby, Inc.*, 580 F. Supp. 2d 273 (S.D.N.Y. 2008); *Pension Comm. Of the Univ. of Montreal Pension Plan v. Banc of America Securities*, 446 F. Supp. 2d 163 (S.D.N.Y. 2006); *Stephens v. Nat'l Distillers & Chem. Corp.*, 1996 U.S. Dist. LEXIS 6915 (S.D.N.Y. 1996); *Greenspun v. Lindley*, 369 N.Y.S. 2d 123 (1975)). For a couple of recent opinions by the

Delaware Court of Chancery which review both traditional and modern choice of law considerations at some length, *see:*

- *Viking Pump, Inc. v. Century Indemnity Co.*, No. 465-VCA (Del. Ch. Oct. 14, 2009), available at http://www.delawarelitigation.com/uploads/file/int25%281%29.pdf; and

- *Total Holdings USA, Inc. v. Curran Composites, Inc.*, No. 4494-VCA (Del. Ch. Oct. 9, 2009), available at http://www.delawarelitigation.com/uploads/file/int6C.PDF.

Thus, given the high level of uncertainty as to how such choice of law disputes will be resolved, it may benefit the parties to enter into a choice of law agreement where there is any room for ambiguity as to which state law will apply to the employment relationship in question. Such an agreement can take a variety of forms, such as a clause in a traditional employment contract, or a separate dispute resolution agreement which may or may not explicitly maintain an at-will employment relationship. Of course, in crafting such agreements, the parties' counsel will want to consider the state of the law in each potentially applicable jurisdiction on the applicability of the Faithless Servant Doctrine, and determine which jurisdiction's laws are most favorable in this regard to the party or parties involved – i.e., whether it will be in the client's interests for the doctrine to be strictly applied, or whether the opposite will be the case.

VI. **Tiered Application Based on Level of Employee Involved**

In determining whether and/or the extent to which the Faithless Servant Doctrine will apply to a given employee in a particular case, the employee's job title and position within the employer's organizational hierarchy may have some legal significance. Several courts have indicated a trend towards construing an employee's fiduciary duties less strictly (or in some cases holding that the employee has no such duties at all), where the employee's job title and/or duties fall beneath some level of managerial responsibility. *See, e.g., Triton Constr. Co., Inc.v. E. Shore Elec. Servs., Inc.*, 2009 Del. Ch. LEXIS 88 (Del. Ch. 2009) (online link to opinion provided *supra*); *Science Accessories Corp. v. Summagraphics Corp.*, 425 A.2d 957 (Del. 1980). Thus, in some jurisdictions, it may be more likely that the Faithless Servant Doctrine will be applied against a disloyal executive or director as opposed to a disloyal lower-level, "rank and file" employee.

VII. **Interaction with "Clawback" and Other Contractual Provisions**

"Clawback" provisions are clauses in employment contracts, typically used in the case of high-level executives, which give the employer the right to cancel the employee's entitlement to bonuses or other compensation, where the employee does not meet some specific condition such as compliance with a non-compete or confidentiality clause. Such provisions have become increasingly popular in recent years, particularly in light of the controversy over government bailouts of financial firms and banks, and the compensation and bonuses paid to executives at those companies.

However, employers may also choose to use such contractual provisions in conjunction with the Faithless Servant Doctrine, in an attempt to further ensure that any compensation paid to an employee during a period of disloyalty can be recovered. In jurisdictions where the Faithless Servant Doctrine is followed, clawback provisions can be used as a fallback to supplement the employer's existing protection under the common law. Similarly, where applicable, employers may choose to utilize such contractual provisions to make up for the fact that the controlling jurisdiction has not adopted or has rejected the Faithless Servant Doctrine.

Conversely, counsel for employees may consider negotiating for contractual language which attempts to limit the applicability, reach, and/or scope of the Faithless Servant and similar doctrines. But when drafting such language, counsel should be wary of the limitations which courts have placed on attempts to contractually waive or otherwise limit an employee's fiduciary duties to his or her employer – particularly in the corporate context. *See, e.g., Sutherland v. Sutherland*, 2009 Del. Ch. LEXIS 46 (March 23, 2009).

For more information on clawback provisions in general, see The Ayco Company, LP, *Clawbacks of Executive Compensation*, Ayco Compensation & Benefits Digest, Volume XVIII Issue II (February 15, 2010), http://www.aycofinancialnetwork.com/news/digest/digest_1002.pdf.

VIII. **Related Cases / Claims**

There are also a number of interesting cases which, while not expressly applying the Faithless Servant Doctrine per se, deal with similar issues involving an employer's attempts to recover compensation or other benefits from allegedly disloyal employees. For example:

- Disloyalty Causes Loss of SERP Benefits:
    - In *Whitescarver v. Sabin Robbins Paper Co.*, 2008 U.S. App. LEXIS 22944 (6th Cir. 2008) (unpublished), the former president of a company was denied SERP benefits by reason of his "disloyalty." The case arose because the former president of a paper company asserted that he had been wrongly denied approximately $300,000 in plan benefits when the company terminated his employment, ostensibly "for cause." Under the plan, which was a SERP, benefits were payable only if the executive were involuntarily terminated without cause.

      It was discovered that the executive had changed the billing on his company-issued cell phone, so bills and call details were mailed to his home instead of to the company's offices. An examination of his cell phone bills reflected prohibited contact with company employees, vendors, and customers. When the company asked for billing detail, the executive refused. Later, the executive was terminated for "cause", including "disloyalty."
- Company Attempts Unsuccessfully to Recover Payments to the Beneficiary of an Allegedly Disloyal Deceased Executive:

- In *Miniace v. Pacific Maritime Assoc.*, 424 F. Supp. 2d 1168 (N.D. Cal. 2006), where the former CEO had approved compensation and benefits for himself, including a split dollar insurance program, without properly informing the company's board of directors, the company made various claims for equitable relief under ERISA section 502(a)(3), in an attempt to recover the benefit payments under that program made to a surviving spouse. While the court held that the CEO had breached corporate fiduciary duties, the court held that it did not constitute a breach of ERISA fiduciary duty, and thus the surviving spouse retained the benefits.

- Forfeiture of Non-Qualified Benefits for Violating a Non-Compete Clause:

  - In *Violette v. Ajilon Finance*, 2005 WL 2416986 (D.N.J. 2005), the court held that it was unreasonable to deny non-qualified deferred compensation benefits for violation of a non-compete where the executive had the burden of proving that he / she had not been in competition with the employer.

IX. **Upshot / Takeaway**

In any employment relationship, particularly at the relationship's outset, counsel for both the employer and prospective employee will want to consider a number of questions, the answers to which will largely determine the scope and reach of the Faithless Servant Doctrine's application. Such questions include:

- What state law will likely apply to the employment relationship? The facts which will most likely factor into this consideration will include (1) the state(s) in which the employee performs the majority of his or her job duties and/or reports to work; (2) any contracts or other agreements between the parties containing choice of law provisions; (3) the state in which the company maintains its principal place of business; and/or (4) the company's state of incorporation or organization. *See, e.g., Hertz Corp. v. Friend*, 130 S. Ct. 1181 (2010) (discussing the contours of the "nerve center" test used to determine the location of a corporation's "principal place of business").

- What does the law of that state or states say about the Faithless Servant Doctrine and/or an employee's duty to reimburse his or her employee for moneys earned while in breach of the fiduciary duty of loyalty to the employer?

- If it is not clear which state law will apply to the employment relationship, will it be in the client's interests to have the parties enter into a choice of law agreement – preferably applying the state law which is most favorable to the client's interests along these lines? If so, should such an agreement be made a part of an employment contract between the parties, or should it instead take the form of a separate dispute resolution agreement?

- Assuming that the state in question applies the Faithless Servant Doctrine or any variation thereof, is its application tiered depending on the level of employee in question? That is, does the state in question apply the doctrine more harshly or more routinely to high-level employees than it does to lower-level employees, and/or does the jurisdiction go so far as to apply the doctrine only to upper-level employees such as directors, officers, and other high-level managers?

- Whether or not the state law in question applies the Faithless Servant Doctrine, will it be in the employer's interests to negotiate for a contractual "clawback" provision – either to supplement the application of the Faithless Servant Doctrine, or to make up for its absence in states where it does not apply? Along these same lines, will it be in the employee's interests to negotiate for a contractual clause attempting to limit the doctrine's application to the extent such limitation is permitted by law?

X. **More Resources**

More information on the Faithless Servant Doctrine and related topics can be found in the following articles:

- Business & Legal Reports, Inc., *Expert Explains New York's Faithless Servant Doctrine*, New York Edition, Issue 429 (June 2010), http://www.jdsupra.com/post/documentViewer.aspx?fid=04ea5829-c46e-4b70-8600-4c25b6214c30.

- James R. Carroll and Jason C. Weida, *Faithless Servants Beware: Massachusetts Forfeiture Law is More Severe than Astra USA, Inc. v. Bildman Might Suggest*, 54 B.B.J. 7 (Winter 2010), http://www.skadden.com/content%5CPublications%5CPublications1989_0.pdf.

- Harvey Randall, *Applying the Faithless Servant Doctrine, Employer Does Not Have to Pay Benefits to Former Employees Found Guilty of Embezzling*, New York Public Personnel Law (February 3, 2010), http://publicpersonnellaw.blogspot.com/2010/02/applying-faithless-servant-doctrine.html.

- Charles A. Sullivan, *More on Faithless Servants*, Workplace Prof Blog (January 29, 2010), http://lawprofessors.typepad.com/laborprof_blog/2010/01/more-on-faithless-servants.html.

- Charles A. Sullivan, Of *Faithless Servants and Efficient Breaches*, Workplace Prof Blog (January 28, 2010), http://lawprofessors.typepad.com/laborprof_blog/2010/01/of-faithless-servants-and-efficient-breaches.html.

- Andre G. Castaybert, *NY Faithless Servant Doctrine*, Guzov Ofsink, LLC (November 11, 2009), http://blog.golawintl.com/2009/11/11/ny-faithless-servant-doctrine/.

- Chaya F. Weinberg-Brodt, *The Faithless Servant Doctrine in New York State*, Withers Worldwide (March 24, 2009), http://www.withersworldwide.com/news-publications/504/the-faithless-servant-doctrine-new-york-state.aspx.

- Tal Marnin, *United States Court of Appeals Clarifies the Forfeiture Remedies Available Under the "Faithless Servant" Doctrine in New York*, White & Case Newsletters (July 2007), http://www.whitecase.com/ecbelfocus_0707_3/.

- John L. Utz, *Implied Right to Reduce Deferred Compensation for Bad Behavior*, Utz Miller & Kuhn LLC (November 6, 2006), www.utzmiller.com/article_display.html?did=MTI=.

- Ronald Minkoff, *Suing Disloyal Employees & Agents: Court Gives Employers a Powerful New Weapon*, Frankfurt Kurnit Klein & Selz, PC's Litigation Advisor Newsletter (April 2004), http://www.fkkslaw.com/newsletter.asp?pageID=2&newsletterID=3.

- Mark A. Jacoby and Marisa A Leto, *Disloyalty Doesn't Pay: New York's "Faithless Servant" Doctrine*, Weil Gotshal's Employer Update (March 2004), http://www.weil.com/news/pubdetail.aspx?pub=8640.

- Stephen M. Bainbridge, *The Faithless Servant Doctrine and Partner (or Agent) Compensation*, ProfessorBainbridge.com (November 9, 2003), http://www.professorbainbridge.com/professorbainbridgecom/2003/11/the-faithless-servant-doctrine-and-partner-or-agent-compensation.html.

- Jeffrey Kohn, *Second Circuit Holds That Disloyal Employee Must Forfeit All Pay*, O'Melveny & Myers LLP (September 23, 2003), http://www.omm.com/newsroom/publication.aspx?pub=323.

- Gary J. Mennitt, *The Faithless Servant Doctrine – Developments in the Law*, Mondaq's Litigation, Mediation and Arbitration Blog (March 2, 2001); http://www.mondaq.com/unitedstates/article.asp?articleid=10298.