



Divided Loyalty: Damages For Employee Disloyalty Claims

At first blush, two principles regarding the loyalty due to a current employer from an employee seem irreconcilable: On one hand, an employee owes his employer complete loyalty; on the other, an employee may incorporate a competitive business prior to departure from employment as long as he does not use his employer's time, facilities or proprietary secrets in the process.¹ Despite the apparent inconsistency between these two modes of conduct, they can peacefully co-exist. However, when they collide—i.e., when an employee fails to honor his duty of loyalty by using his employer's time and facilities to get a "head start" on a soon-to-be competitive business—litigation often follows.

The Appellate Division, First Department's 1984 decision in *Maritime Fish Products Inc. v. World-Wide Fish Products Inc.*² is one of the leading decisions on the ramifications of employee disloyalty. In *Maritime Fish*, plaintiff sold dried fish purchased from Canadian packers to wholesale distributors and retail chains throughout the United States. Maritime's president, Roald Hertzwig, hired his cousin, Roy Christensen, as a salesperson for the New York market. From the time of his hiring in 1970, Mr. Christensen rose quickly through the ranks, was named vice president in July 1976, and became the sole signatory of Maritime's checking account. Mr. Christensen was not bound by a restrictive covenant during his tenure with Maritime.

In 1974, without informing Maritime, and following the lead of a Maritime customer, Mr. Christensen found a buyer in the Dominican Republic known as Frutos. Mr. Christensen later confirmed that he never advised Maritime of this opportunity but decided to take the opportunity for himself. Having a customer in place, Mr. Christensen contacted Maritime's resident buyer of dried fish in Canada, Graham Garrison. Soon thereafter,

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Garrison located a source of supply. Defendant World-Wide's first sale to Frutos was made in January 1976, within weeks of World-Wide's incorporation. By June 1976, World-Wide had completed four other transactions with Frutos. Maritime was kept completely in the dark about these transactions.

Mr. Christensen resigned from Maritime in February 1977 and began to work for World-Wide. Unbeknownst to Maritime, Mr. Christensen had secretly incorporated World-Wide 14 months earlier, hiring his wife as secretary/

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treasurer and his father-in-law as vice president.

The court ruled that World-Wide competed directly with Maritime. In reversing that portion of the trial court order which dismissed plaintiff's employee disloyalty claim, the First Department found:

On this record, it is apparent that Christensen abandoned all pretense to the loyalty expected of a trusted employee. He surreptitiously organized a competing organization, corrupted a fellow employee, and secretly pursued and profited from one or more opportunities properly belonging to his employer. ... Christensen was not just preparing to go into his own business; he was in business for himself, while drawing a salary from a trusting employer.³

The remedy awarded to plaintiff was significant: the court held that plaintiff was entitled to, *inter alia*, an accounting to ascertain the damages resulting from Mr. Christensen's diversion of business from the date of World-Wide's incorporation until Mr. Christensen's resignation from Maritime.

Means of Establishing Loss

Citing the Court of Appeals' decision in *Duane Jones Co. v. Burke*,⁴ the First Department ruled in *Maritime Fish* that a plaintiff is "entitled to damages for the wrongful diversion of its business measured by the opportunities for profit on the accounts diverted from it through defendant's conduct."⁵ Eighteen years later, in *Gomez v. Bicknell*,⁶ the Second Department issued its first opinion addressing the law of damages for an employee's "breach of a duty of loyalty in converting to himself a corporate opportunity." In *Gomez*, the Second Department instructed that an employer may select one of two avenues to establish its damages incident to an employee's disloyalty.

[T]he remedy for breach of fiduciary duty is not only to compensate for the wrongs but to prevent them. The remedy, not unlike applying a constructive trust, is disgorgement for breach of the loyalty an employee owes to the employer. This is not to say that other methods of calculating an employer's damages are unavailable. As an alternative to an accounting of the disloyal employee's claim, calculation of what the employer would have made of the diverted corporate opportunity is an available measure of damages. The choice of remedy belongs to the employer [internal citations omitted].⁷

The Second Department's *Gomez* decision essentially permits the employer to shift the burden in establishing damages sustained as a result of employee disloyalty. Of course, consistent with the *Maritime Fish* decision, an employer may elect » Page 9

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to affirmatively assume the burden of establishing its lost opportunities for profit.⁸ Or, relying upon the *Gomez* alternative, the employer may simply put the onus on the disloyal employee:

For disgorgement of Gomez's profits stemming from disloyalty, all BAS needed to show was the gross fee Gomez received. We conclude that BAS met this prima facie burden of showing damages by simply proving the \$353,000 gross fee that Gomez was paid. The burden then shifted to Gomez to demonstrate the amount of his direct costs in generating this gross income because he is in exclusive possession of that information. BAS would then have the opportunity to question the reasonableness of any deduction.⁹

Losses and Compensation

As set forth in *Maritime Fish and Gomez*, recovery in an employee disloyalty case may be premised upon the economic loss sustained by the former employer. Moreover, the employer's economic loss may be assessed on two distinct bases. Thus, in *Carco Group Inc. v. Maconachy*, Magistrate Judge Arlene Lindsay of the Eastern District of New York issued a decision awarding the plaintiff economic loss damages premised upon breach of an asset purchase agreement and employment agreement, and also simultaneously awarded damages based upon the defendant's disloyalty. The result was that the court

awarded one set of damages for breach of the relevant contracts, and another set of damages arising from breach of the employee's duty of loyalty.

According to the court, in *Carco Group Inc. v. Maconachy*,¹⁰ Drew Maconachy had co-founded Murphy & Maconachy Inc. (MMI), a security consulting firm that offered investigation and litigation support services. Carco's majority owner had focused on MMI for its targeted expansion because the principals of both companies were former FBI agents and because MMI could provide Carco a foothold in the investigative services field. MMI had been in business for 15 years prior to its acquisition by Carco, which provided research and background check services and was seeking to expand its operations to include investigative services.

Carco acquired the assets of MMI on Jan. 7, 2000, via an asset purchase agreement (APA) and employment agreements (EA)¹¹ for John Murphy and Mr. Maconachy. The EAs were a condition precedent to the APA and were explicitly described to be an integral part of the APA, primarily because a report prepared by Merrill Lynch regarding MMI's value concluded that MMI's revenue generation was heavily dependent upon Messrs. Maconachy and Murphy, and that MMI's business was derived principally through professional relationships and word of mouth.

Subsequent to the closing of Carco's purchase of MMI, MMI began to sustain significant losses. Over the course of several years, Carco insisted that Mr. Maconachy follow a certain sales and expense reduction plan in an attempt to remedy

the declining revenue. After a four-week bench trial, the court made findings of fact, which included a painstakingly detailed account of Mr. Maconachy's consistent refusal to follow Carco's plans and directives. That ongoing refusal ultimately resulted in the award to plaintiff of damages premised upon breach of the APA and EA.

Part and parcel with Maconachy's breach of his duty to perform was Maconachy's repeated and consistent failure to comply with the tasks assigned to him by [Carco]. The record is rife with examples...¹²

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At every turn, Maconachy failed to comply with the reasonable duties and directions given to him by his superiors. Accordingly, due to the acts described above that show a wanton disregard of reasonable instructions from supervisors, the court finds that Maconachy breached the [APA and EA].¹³

The court concluded that the failure to perform as directed, in breach of the APA and EA, entitled the plaintiff to damages in an amount equal to the economic loss that it suffered for the period November 2000 through December 2002.¹⁴

The court's findings of fact also revealed that Mr. Maconachy had intentionally attempted to conceal his hiring of family members by falsifying time records which were submitted for review by Carco's hierarchy, and found that Carco was entitled to damages based upon the falsification of the time records.

Maconachy's contractual obligations under the Performance Clause were the duties of reasonable performance and to follow directions. In contrast, Maconachy's fiduciary duty was to act on Carco's behalf and to avoid self-dealing. The

altering documents gives rise to a separate claim of breach of fiduciary duty that is distinct from Carco's breach of contract claims.¹⁵

Further, forfeiture of this amount does not constitute double recovery of Carco's breach of contract claims because those damages derive from a separate period of time from November 2000 to December 2002. The court is unaware of any authority under New York law limiting recovery under both a theory of breach of contract and breach of fiduciary duty, except where the two claims are duplicative as described above. Therefore, Carco is entitled to an award of \$889,711, which constitutes the compensation paid to Maconachy during his period of disloyalty from September 26, 2003 [the date of the first falsification] to December 28, 2005 [the date of termination].¹⁶

In sum, the court concluded that "despite the many directives he received, Mr. Maconachy never implemented the sales plan"¹⁷ and MMI's "business was failing from a lack of management and the absence of any good faith effort to follow corporate directives [regarding sales and expense reduction]."¹⁸ The *Carco* court essentially concluded that Mr. Maconachy's disloyalty was all-encompassing; the corresponding array of damages was devastating to the defendant.

Conclusion

Counsel's initial analysis of the potential damages in employee

disloyalty claims serves as the keystone to the prosecution or defense of such claims. Any analysis must begin with a complete command of the events which occurred during the employee's tenure of employment so that counsel can evaluate whether broad-based damages are viable.

1. 30 FFS Production Inc. v. Livolsi, 68 A.D.3d 1101, 891 N.Y.S.2d 162 (2d Dept. 2009).

2. 100 A.D.2d 81, 474 N.Y.S.2d 281 (1st Dept. 1984).

3. Id., at 88, 285-86.

4. 306 N.Y. 172 (1954).

5. 100 A.D.2d 81, at 91, 474 N.Y.S.2d 281, at 287 (1st Dept. 1984).

6. 302 A.D.2d 107, 756 N.Y.S.2d 209 (2nd Dept. 2002).

7. Id., at 113-14, at 214.

8. "[A] plaintiff who proves a breach of contract may recover lost profits contract only by showing: (1) that the damages were caused by the defendant's breach; (2) that the lost-profit damages are 'capable of proof with reasonable certainty'; and (3) that such damages were 'fairly within the contemplation of the parties to the contract at the time it was made.'" *Spherenomics Global Contact Ctrs. v. Customer Corp.*, 427 F.Supp.2d 236, 251 (E.D.N.Y. 2006) (quoting *Kenford Co. Inc. v. County of Erie*, 67 N.Y.2d 257, 261, 502 N.Y.S.2d 131 (1986)).

9. 302 A.D.2d 107, at 114-15, 756 N.Y.S.2d 209, at 215 (2d Dept. 2002).

10. 644 F.Supp.2d 218 (E.D.N.Y. 2009).

11. According to the court, Carco considered Messrs. Murphy and Maconachy to be so essential to the purchase that it required each of them to sign "unusually long" employment agreements of eight years, a period of time which coincided with Carco's repayment term of a bank loan obtained to acquire MMI.

12. 644 F.Supp.2d 218, 233 (E.D.N.Y. 2009).

13. Id., at 234.

14. Although MMI West was profitable between 2003 through Mr. Maconachy's termination in December 2005, the court found that such profitability was due to other measures not attributable to Mr. Maconachy's actions.

15. 644 F.Supp.2d 218, 243 (E.D.N.Y. 2009).

16. Id., at 244.

17. Id., at 228.

18. Id., at 230.