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Disgorgement of Disloyal Employee's Compensation Now Available to Employers

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As management attorneys in New Jersey we find our courts generally favor employees over management. Despite this history, our Supreme Court recently handed a victory to employers when it expanded the equitable remedies available to them following an employee's breach of the duty of loyalty. In Kaye v. Rosefielde, the Supreme Court held that disgorgement of a disloyal employee's compensation is an appropriate remedy, even if the employee's conduct did not cause the employer to sustain an economic loss.

Background

The Defendant in Kaye was the Chief Operating Officer and General Counsel of several companies owned by the Plaintiff until he was terminated for engaging in self-dealing and diverting opportunities away from his employer for his personal financial gain. The trial court found that over the course of his two-year employment, Kaye engaged in egregious conduct constituting breaches of his duty of loyalty, fiduciary duties, legal malpractice, and fraud, and awarded Plaintiff compensatory damages, punitive damages, and over $800,000 in legal fees. However, the trial court denied the employer's request for disgorgement and return of all payments, profits, disbursements, and other funds paid to Kaye by virtue of his employment because there was no evidence that Kaye's actions resulted in actual damages to his employer. The Appellate Division affirmed.

Supreme Court's Decision

On appeal, the Supreme Court held that the equitable remedy of disgorgement is appropriate in a breach of the duty of loyalty case, even without evidence that the employer sustained an economic loss as a result of the employee's disloyal actions. Finding that disgorgement of past compensation is a remedy derived from contract law, the Court reasoned that the duty of loyalty is the foundation of the employment relationship. Therefore, an employee who is found to have breached his duty through disloyal activities should be compelled to forego any compensation earned during the period of betrayal. In sum, the Court opined that "compensation during a period in which the employee is disloyal is, in effect, unearned."

Further, the Court found that requiring an employer to demonstrate economic loss as a result of an employee's disloyal activities is inconsistent with the basic premise of disgorgement as a remedy. Employees are paid salaries or other compensation in exchange for the expectation that they will perform their job duties in a loyal manner. Breach of the duty of loyalty constitutes an employee's failure to perform the job duties for which he was paid. As a result, an employee must not be permitted to benefit economically for the time during which the employee was paid but violated fiduciary duties to the employer.

The Court stated that the question of whether disgorgement is appropriate in a given case is a fact-sensitive inquiry. To guide this inquiry, the Court identified the factors future courts should consider: (1) the employee's degree of responsibility, status, and level of compensation with the employer; (2) the number of disloyal acts; (3) the extent to which the employee's actions placed the employer's business in jeopardy; (4) the extent and degree of the employee's planning to undermine the employer; and (5) other factors that may guide the court in determining the appropriateness of an equitable remedy, including, for example, the existence of any contractual provisions relevant to the employee's actions, the extent to which the employer had knowledge of the employee's actions, and the effect of the employee's conduct on the employer's business. Finally, the Court found that disgorgement of an employee's salary should be apportioned to the misconduct at issue, rather than wholesale disgorgement, for example, for the periods of time during which the employee actually engaged in disloyal activities.

What Does This Mean for Your Organization?

While employers were previously able to recover lost profits as a result of an employee's quantifiable breach of fiduciary duties, Kaye creates an opportunity for employers to use the duty of loyalty as a sword against disloyal employees even in the absence of economic loss. The decision could also act as a deterrent for employees considering engaging in activities contrary to their employers' interests. Therefore, New Jersey employers should remain vigilant when faced with employees suspected of engaging in disloyal activities.

If you have any questions about how this decision could affect your organization, or the availability of disgorgement under a specific set of circumstances, please contact Scott Ohnegian, Daniel Zappo, or any member of Riker Danzig's Labor & Employment Group.

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