International fraud and asset tracing litigation - Spring: The faithless servant doctrine in New York State

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The touchstone of the employer/agent relationship has long been faithful services in exchange for agreed-upon compensation. In troubled economic times, however, cases involving allegations of "faithless service" may increase for a variety of reasons. For example, (i) agents may feel pressure to look after their own interests; (ii) economic distress may bring long-standing, concealed fraud to light; (iii) employers may perceive deliberate disloyalty where negative outcomes result from outside force; or (iv) employers, in response to pressures of their own, may create or over-state these accusations.

In New York, employers and principles have a powerful tool at their disposal – the "faithless servant" doctrine under which a deliberately disloyal employee or agent may, under certain conditions, forfeit any right to compensation during the period of disloyalty. While an employer may obtain disgorgement for the entire time period of deliberate disloyalty, disgorgement is not generally available for the time period either before or after the disloyalty, if the servant provided faithful service for some period of time. See Design Strategy, Inc. v. Davis, 469 F.3d 284, 301 (2d Cir. 2006). However, disgorgement may be required even if the employer suffered no damages from the employee's disloyalty, because one of the primary purposes of this doctrine is to remove all incentive for a servant to be faithless. South Pierre Assocs. v. Meyers, 12 Misc.3d 955, 960-61 (Civ. Ct. N.Y. Cty. 2006).

While the doctrine is over a century old, see Murray v. Beard, 102 N.Y. 505 (1886), its parameters are still being debated in the New York courts. See Phansalkar v. Andersen Weinroth & Co., L.P., 344 F.3d 184 (2d Cir. 2003). Phansalkar is a significant case, not necessarily because it broke new legal ground, but because of the substantial dollar forfeiture imposed on the disloyal employee, i.e., $4,417,655.40 (plus pre-judgment interest), demonstrating just how severe the application of this doctrine may be for employees.

In Phansalkar, an employer refused to pay a departing employee significant compensation after it learned that he had been disloyal with respect to numerous company transactions. The lower court found that while the employee had been deliberately disloyal and unfaithful in six separate transactions over a substantial period of time, his disloyalty had not permeated all of his services, and therefore he was entitled to over $4 million in compensation on a separate transaction, where he had not been disloyal.

The federal appellate court reversed, and held for the employer. While it found New York law unclear on the appropriate standard of liability, it further found that the employee had been unfaithful under either standard.

In finding for the employer, the Phansalkar court considered and rejected the employee's argument that his forfeiture should be apportioned, and therefore limited only to those transactions in which he had been disloyal. Phansalkar instead held that where deliberate malfeasance and faithless service occurs in most of an employee's areas of responsibility and continues over many months, New York State law would not allow the employee to retain the benefits of any of the compensation he earned during his period of deliberate disloyalty. The Phansalkar court further explained that while New York law might allow apportionment of forfeiture under some circumstances, this partial defense was available only where three separate criteria are met. (1) the parties had agreed that the agent would be compensated on a task-by-task basis; (2) the agent engaged in no misconduct with respect to certain specific tasks; and (3) the agent's disloyalty with respect to other tasks, "neither tainted nor interfered with the completion of the tasks," where he was loyal. 344 F.3d at 205, quoting Musico v. Champion Credit Corp., 764 F.2d 102, 114 (2d Cir. 1985), and accord G.K. Alan Assoc., Inc. v. Derval Lazzari, 44 A.D.3d 95, 103-04 (2d Dep't 2007).

Under the three "apportionment" criteria, employees who receive general compensation in the form of salaries will most likely be unable to limit their disgorgement to specific tasks or transactions, unless there was an agreed-upon, clear apportionment of compensation by specific task. See Phansalkar, 344 F.3d at 208; cf. Design Strategy, Inc. v. Davis, 469 F.3d 284, 301 (2d Cir. 2006) (where employee was compensated with a general salary plus commissions for specific tasks, disgorgement was limited to salary for the four-week period in which he had been disloyal, but did not effect the specific commissions he earned on the separate tasks, where employee had acted loyally). Indeed, where disloyalty is pervasive and repeated, an apportionment defense may be rejected even where it is raised by an independent agent, who may be forced to disgorge all compensation earned during the period of disloyalty. In re Blumenthal v. Kingsford, 32 A.D.3d 767, 768 (1st Dep't 2006) (where agent's disloyalty was systemic, the court would not apportion salaries and commissions; all earnings during the period of disloyalty, amounting to $1,904,604 plus interest, were disgorged). The remedy available is indeed often draconian, but in Blumenthal, the New York State Appellate Division, First Department nevertheless "decline[d] the invitation to abolish the faithless servant doctrine, which has long been the law of this State." 32 A.D.3d at 768; but cf. Seven Hanover Assocs., LLC v. Jones Lang LaSalle Americas, Inc., 2008 U.S. Dist. Lexis 12304 (S.D.N.Y. Feb. 19, 2008) (refusing to consider the application of the faithless service doctrine, because it would lead to an unjust forfeiture).

Because the remedy for employee disloyalty is indeed so drastic, employers may sometimes have the unfortunate incentive to wrongfully accuse employees or agents of deliberate disloyalty. Courts must therefore carefully scrutinize these allegations and deny forfeiture claims where negative business outcomes result from factors other than deliberate disloyalty. Indeed, there are reported cases where courts have penalized employers who alleged deliberate dishonesty and sought forfeiture as counterclaims against employees as a reaction to, or in retaliation for, a colorable claim by the employee against the employer. See, e.g., Torres v. Gristede's Operating Corp., 2008 U.S. Dist LEXIS 6606 (S.D.N.Y. 2008) (employer's counterclaims for dishonest assistance were so flimsy that they amounted to retaliation against employees for bringing wage-and-hour claims, in violation of the Fair Labor Standards Act which prohibits such retaliation).

Given that the possibilities of (i) deliberate employee disloyalty and misconduct; (ii) negative results that appear to be the result of deliberate disloyalty but are not; and (iii) false or overstated employer accusations, each case must be carefully scrutinized by the court, which must tease out what actually happened from the conflicting facts presented. See Webb v. Robert Lewis Rosen, Assocs., 2004 U.S. Dist. LEXIS 12024 (S.D.N.Y. 2004) (parsing conflicting testimony, and finding for agent, where evidence of faithful service was more credible and persuasive than contrary evidence of disloyalty), aff'd 2005 U.S. App. LEXIS 5710 (2d Cir. 2005) (summary order). For this reason, employers, principals, employees or agents, when faced with allegations of faithless service in New York are well-advised to seek legal advice in the early stages of events, and (if at all possible) before proceedings are commenced.

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