N.J. SUPREME COURT LESSENS BURDEN TO PROVE ENTITLEMENT TO DISGORGEMENT OF SALARY IN CASES INVOLVING DISLOYAL EMPLOYEES

By Kevin J. O'Connor*

New Jersey's Supreme Court has rendered another ground breaking decision in the employment and closely-held shareholder context, this one Kaye v. Rosefielde, decided today.

In Kaye v. Rosefielde, 432 N.J. Super. 421 (App. Div. 2013), the Appellate Division had affirmed a number of rulings by the lower court in a dispute between a business and its owners and an attorney who had served as general counsel for the business and had allegedly defrauded plaintiffs. The Court granted certification to decide whether "the Appellate Division err[ed] by affirming the trial court's holding that economic damages are a necessary prerequisite for disgorgement of the employee's salary…."

The Court in Kaye reversed the Appellate Division's rulings, and the decision could have broad implications in any number of contexts where a disloyal employee is sued and the employer seeks the equitable remedy of disgorgement of earnings during the period of disloyalty.

Anyone who has handled a chancery matter involving employee disloyalty knows how difficult it can be to prove actual economic damages to a business tied to the disloyalty of an employee. Such was the case in Kaye. Plaintiff Bruce Kaye, the controlling principal of three entities that sell and manage timeshare interests in resort properties in Atlantic County, hired defendant Alan P. Rosefielde, an attorney admitted to practice law in New York but not in New Jersey, initially as outside counsel, and then as an employee. After defendant had worked closely with plaintiff for approximately four months, the parties entered an agreement providing that, as compensation for his services, defendant would earn an annual salary of $500,000. For approximately two years, defendant served as Chief Operating Officer for several of the timeshare entities, and effectively functioned as their general counsel. In that capacity, defendant committed serious misconduct by acting on his own behalf instead of for his employers' benefit, and exposing his employers to potential liability. Based on this misconduct, and dissatisfaction with defendant's performance, plaintiff terminated defendant's employment.

Plaintiff Kaye and the companies that employed defendant commenced suit against defendant, asserting claims for breach of fiduciary duty, fraud, legal malpractice, unlicensed practice of law, and breach of the duty of loyalty. In addition to claiming compensatory and punitive damages for the alleged disloyalty, plaintiffs sought rescission of the parties' agreements and disgorgement of monies received by defendant or his company. Following a lengthy trial, the court found that defendant engaged in egregious conduct, including self-dealing, fraudulent acquisition of an ownership interest in one of the entities, and conspiracy to forge deeds to various properties, which the court held to constitute a breach of his duty of loyalty, breach of fiduciary duty, legal malpractice, and civil fraud. The trial court rescinded defendant's interest in several entities, and awarded compensatory damages, punitive damages and legal fees. Although the trial court stated that it is difficult to imagine the commission of more egregious conduct by a corporate officer, it declined to order the equitable disgorgement of defendant's salary as a remedy for breach of the duty of loyalty, because the breach did not result in any actual damage to the plaintiff entities, which it believed was required by Cameco, Inc. v. Gedicke, 157 N.J. 504 (1999). The Appellate Division affirmed in part, and reversed in part, the determinations by the trial court. The trial court's determination that plaintiffs were not entitled to the remedy of disgorgement was affirmed. 432 N.J. Super. 421 (App. Div. 2013).

The trial judge in Kaye was certainly not alone in believing that Cameco required proof of some causal nexus between the disloyalty and actual harm to the employer, and this is an argument that is repeatedly made by counsel defending such claims. While Cameco had implicitly stated that no such causal nexus was required, courts have wrestled with the degree of proof needed in order to trigger this equitable remedy. Writing for the Court, Justice Patterson put the issue to rest, and observed that Cameco has always allowed disgorgement even in the absence of monetary damages proximately caused by the employee's disloyalty.

The Court remanded the case and directed the trial court to consider the following factors in deciding whether disgorgement is an appropriate remedy:

1. the employee's degree of responsibility and level of compensation;
2. the number of acts of disloyalty;
3. the extent to which those acts placed the employer's business in jeopardy; and
4. the degree of planning to undermine the employer that is undertaken by the employee.

The Court in Kaye further ruled that, where disgorgement is appropriate, a trial court should apportion the employee's compensation, rather than ordering a wholesale disgorgement that may be disproportionate to the misconduct at issue.

This decision will make it easier for employers to recover from disloyal employees where the disloyalty does not result in direct financial harm to the employer. For instance, if a fellow shareholder with whom the other shareholders have an agreement that they will not pursue outside commercial interests, creates competing business and devotes substantial time to the other business, a claim could be made to disgorge a salary paid to the shareholder during the time he was working with the competing business. The Court's decision to characterize the availability of this relief as a legal determination will not obviate the need for discovery when such claims are made given the fact specific test it has set out in Kaye.

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