

DEPARTING OFFICERS' AND EMPLOYEES' FIDUCIARY DUTIES

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Many companies, large and small, face the challenge of preserving their business clients and continuing their operations after key officers have given notice of their intended separation or other termination from the business. Because these key employees often are responsible for maintaining essential customers and other key personnel, the companies and the departing officers are concerned with defining their legitimate pre-termination activities. Can they make arrangements to start a competing business, contact or solicit the company's customers for their new business, encourage other company employees to join them, or copy company records to provide them post-termination information? Answers to these questions can be provided from developed case law in Illinois and are often dependent upon the particular position of the departing officer and whether restrictive covenants or non-competition agreements are in place.

NON-OFFICER EMPLOYEES

In the absence of restrictive covenants, the improper taking of confidential customer lists, or fraud, former employees may compete with their former employers and solicit the business of former customers, provided there is no demonstrable business activity by the former employee before termination of his employment. *Prudential Insurance Co. of America v McCurry*, 143 Ill App 3d 222, 492 NE2d 1026, 97 Ill Dec 367 (3d Dist 1986). Further, while still employed, non-officer employees may plan, form, and outfit a competing

business as long as they do not actually commence competition. *Voss Engineering, Inc. v Voss Industries, Inc.*, 134 Ill App 3d 632, 481 NE2d 63, 89 Ill Dec 711 (1st Dist 1985).

Even if the employee is a shareholder of the company, he would have to be in a position to hinder, influence, or control the corporation to have fiduciary duties to the other shareholders of a corporation. *Dowell v Bitner*, 273 Ill App 3d 681, 652 NE2d 1372, 210 Ill Dec 396 (4th Dist 1995). A mere owner of stock, especially where less than a controlling interest is held, does not owe a fiduciary duty to the company. *Hagshenas v Gaylord*, 199 Ill App 3d 60, 557 NE2d 316, 145 Ill Dec 546 (2d Dist 1990). See also 805 ILCS 5/6.40.

Prior to termination, an employee owes a fiduciary duty not to solicit customers away from the employer while still in its employ. *Prudential Insurance Co. v Van Matre*, 158 Ill App 3d 298, 511 NE2d 740, 110 Ill Dec 563 (5th Dist 1987). Most cases in this area deal with insurance salesmen/employees. Once these employees leave the service of the employer, they no longer owe a fiduciary duty to the employer and are free to compete with their former employer. *Prudential Insurance Co. v Sempetrean*, 171 Ill App 3d 810, 525 NE2d 1016, 121 Ill Dec 709 (1st Dist 1988).

However, the existence of an express restrictive covenant (not to compete for a period after termination) is an exception to the rule. Such cases stand or fall on the basis of contract law. *Composite Marine Propellers v Van Der Woude*, 962 F2d 1263 (7th Cir 1992). In the *Prudential Insurance Co. v Van Matre* (supra) case, the employee/sales agent had no post-termination agreement restricting competition with the employer. Prudential alleged Van Matre tortiously interfered with its existing life insurance contracts by inducing the policyholders to terminate their policies and purchase new policies with his new employer. The court recognized the Illinois rule that causing the termination of a contract, even those

terminable at will, intentionally and without just cause is actionable. Prudential alleged the wrongful means used by Van Matre (as required to establish a case for tortious interference) was the use of customer lists and policyholder information he had access to during his employment. However, the Court noted Prudential never alleged such information was treated as confidential or was surreptitiously obtained by Van Matre. In such case, where others in the field commonly know the information or can easily duplicate it, or where competitors know the employer's customers, the information does not constitute a protectible trade secret, and Van Matre's actions were not found to be tortious. *American Wheel & Engineering Co. v Dana Molded Products, Inc.*, 132 Ill App 3d 205, 476 NE2d 1291, 87 Ill Dec 299 (1st Dist 1985). See generally the Illinois Trade Secrets Act 765 ILCS 1065/et seq.

Illinois courts will also imply an agreement of the employee to refrain from doing anything which will destroy or injure the other party's right to receive the fruits of the contract. *Prudential Insurance Co. v McCurry*, 143 Ill App 3d 222, 492 NE2d 1026, 97 Ill Dec 367 (3d Dist 1986). However, it is the contract between the employer and the employee and the rights inuring to each party which are the "fruits of the contract" under this rule, not the contracts and premiums therefrom generated by the employee for the employer. These are the fruits of the contract with the customer. After termination of the employment (agency) contract and absent an express covenant to the contrary, a former employee may negotiate for his own interest and may act adversely to his former principal (*McCurry* (supra)). Soliciting business from the former employer's customers after termination is not prohibited, absent an enforceable restrictive covenant, and will not be implied as covenants as a matter of law. (*Van Matre* (supra)). Citing to public policy against the restraint of trade, courts reviewing these cases have stated: "Our free economy is based upon competition.

One who works for another cannot be compelled to erase from his mind all of the general skills, knowledge, acquaintances and the over-all experience which he acquired during the course of his employment.” *Revcor, Inc. v Frame, Inc.*, 85 Ill App 2d 350, 357, 228 NE2d 742, 746 (2d Dist 1967).

Prohibited demonstrable business activity by an employee before termination showing competition with the employer is case dependent. Creating a customer database for the new employer, soliciting other employees of the employer to become employees of the new business, and actively soliciting customers of the employer for the new business are clearly actionable. *Everen Securities, Inc. v A.G. Edwards & Sons, Inc.*, 308 Ill App 3d 268, 719 NE2d 312, 241 Ill Dec 451 (3d Dist 1999); *ABC Trans National Transport, Inc. v Aeronautics Forwarders, Inc.*, 90 Ill App 3d 817, 413 NE2d 1299, 46 Ill Dec 186 (1st Dist 1980). Actions indicating bad faith of the employee, such as copying the employer’s confidential files (and later burning the client files upon notice of litigation [*Everen* case]) serve to improve the employer’s case. While there is some overlap in the rules prohibiting conduct of employees prior to termination to those affecting termination of officers and directors, the fiduciary duties for the latter are significantly enhanced.

HEIGHTENED FIDUCIARY DUTIES OF OFFICERS AND DIRECTORS

Corporate officers (and directors) stand on a different footing from other employees; they owe a fiduciary duty of loyalty to their corporate employer not to (1) actively exploit their positions within the corporation for their own benefit, or (2) hinder the ability of a corporation to continue the business for which it was developed. *Veco Corp. v Babcock*, 243 Ill App 3d 153, 611 NE2d 1054, 183 Ill Dec 406 (1st Dist 1993), citing *Smith-Shrader Co. v*

Smith, 136 Ill App 3d 571, 577, 483 NE2d 283, 91 Ill Dec 1 (1st Dist 1985). This fiduciary duty of loyalty is not inconsistent with a former general employee's right to enter into competition with a former employer upon leaving such employment. Resignation of an officer will not sever his liability for transactions completed after termination which began during the officer's employment or which are founded on information acquired during the employment relationship. *Comedy Cottage, Inc. v Berk*, 145 Ill App 3d 355, 360, 495 NE2d 1006, 99 Ill Dec 271 (1st Dist 1986). Illinois courts have applied this heightened loyalty standard in a number of moderate to severe officer misconduct cases.

In the *Veco* (supra) case, an officer-employee with authority over all of the employer's group and employee benefits insurance clients, joined with other key employees to plan and form a new business to compete with Veco. Their activities to locate and lease office space and to order office equipment, telephone systems, and computer software passed the Court's scrutiny. However, evidence of their direct attempts while employed with Veco to obtain the business of a large Veco client through meetings with the client's representatives and making expressions that the entire Veco staff responsible for servicing that client's account would be leaving were not overlooked by the Court. While the client solicited did not actually transfer its business to the departing officer's new business, it did leave Veco; and other Veco clients did transfer their business to the officer's new corporation beginning the day after his termination. Citing *ABC Trans National Transport, Inc.* (cited later), the Court noted that certainly this could not have occurred absent defendants' prior careful planning. The departing officers were also found to have secretly solicited Veco's employees for their new business and to have orchestrated a mass exodus of Veco's personnel such that Veco could thereafter not properly service its clients. These actions were

found to be active exploitation of the officers' positions to enhance their individual interests at the expense of their employer, and constituted breaches of their fiduciary duties.

In *Preferred Meal Systems, Inc. v Guse*, 199 Ill App 3d 710, 557 NE2d 506, 145 Ill Dec 736 (1st Dist 1990), officers and directors were found to have breached their fiduciary duties when they used the company's confidential business information for their new business, both before and after their departure, and orchestrated a mass exodus of employees shortly after their resignations.

In *Unichem Corp. v Gurtler*, 148 Ill App 3d 284, 498 NE2d 724, 101 Ill Dec 400 (1st Dist 1986), the company president's son, a company salesman, resigned and formed his own rival chemical company. The president did not inform the board of directors of his son's resignation or plans for a competing company, and encouraged plaintiff's employees to work for his son's company. He arranged below market sales of the plaintiff's products to his son's company, which turned around and sold the products to plaintiff's regular customers. The defendant eventually resigned and became president of his son's company. In this obviously extreme case, the court held the officer/director had breached his fiduciary duties to plaintiff not only by his actions, but by his failure to disclose facts which threatened the plaintiff's existence and his intentional misrepresentation and secreting such facts.

Similarly, in *Vendo Co. v Stoner*, 58 Ill2d 289, 321 NE2d 1 (1974), an officer/director of a vending machine manufacturer was found to have violated his fiduciary duties to his company by contributing without disclosure substantial personal funds to the development of a superior vending machine for another firm which would compete with his employer. The officer/director had even represented his company in failed negotiations to purchase the new

machine. The court found this provided strong indication the officer/director actually misled his employer while purportedly acting as its agent.

In *ABC Trans National Transport, Inc. v Aeronautics Forwarders, Inc.*, 62 Ill App 3d 671, 379 NE2d 1228, 20 Ill Dec 160 (1st Dist 1978), the president of a company and the vice presidents of its subsidiary invested in and formed a competing freight forwarding company. They solicited the plaintiff's customers and encouraged plaintiff's staff to work for the rival corporation advising them that plaintiff's subsidiary would soon be insolvent. The officers even encouraged plaintiff's employees to use plaintiff's facilities, funds, and personal property to pre-stamp the rival corporation's air bills, to provide it office supplies and airline containers, and to prepare its daily reports. Based on these facts the Court held that an injunction to prevent these officers and the competing company they formed from soliciting or servicing the plaintiff's former customers was proper.

In a recent case with less egregious action by the officers/directors, the court was unwilling to find breach of fiduciary duty. *Cooper Linse Hallman Capital Mgmt v Hallman*, 368 Ill App 3d 353, 856 NE2d 585, 305 Ill Dec 780 (1st Dist 2006). There an officer and another employee of an investment market timing firm formed a firm to compete with their employer. In addition to leasing office space for the new firm, buying office equipment, and filing articles of incorporation, the officers copied prospect lists, customer account spreadsheets, customer mailing labels, and other documents of the plaintiff and used the plaintiff's computer to type a business plan and advertisements. The plaintiff also alleged the defendants solicited a major client of plaintiff before their termination of employment, which client transferred its business to the new firm seven months after defendants' termination. Defendants denied soliciting the client, claiming only to have carried out plaintiff's business

in pre-termination meetings. The court ruled the defendants did not violate their fiduciary duties to their company, noting they did not steal property of the company to operate a rival business, did not begin doing business while still employed by plaintiff, and did not interfere with plaintiff's customers nor impede plaintiff's ability to conduct its business. Finally, the court found the defendants had not engaged in the "monkey business" of the previously recited cases. The court stated that "to rule otherwise would be to virtually prevent all officers and directors from seeking new employment prior to resigning from their current positions."

Further notably, the rules regarding fiduciary duties of officers and directors have been extended to lawyer partners of law firms who left to create competing firms. *Dowd & Dowd, Ltd. v Gleason*, 352 Ill App 3d 365, 816 NE2d 754, 287 Ill Dec 787 (1st Dist 2004). In this opinion, the court's discussion encourages departing attorneys to give clients an informed choice as to who will manage their business in light of changes in employment or business structure and in light of the attorney-client relationship. Further, the Court reminded current law firms to allow attorneys to move freely without hindrance from them. Notwithstanding these statements, the reviewing court upheld the trial court's finding of pre-termination solicitation of one of plaintiff's substantial clients as a breach of fiduciary duty. Further, the departing attorneys were found to have breached their fiduciary duties by voting and accepting large bonuses for themselves without disclosure, leaving the employer stripped of its cash reserves, and by arranging a mass exodus of employees to their new firm.

SIGNIFICANT DAMAGES FOR BREACH OF FIDUCIARY DUTIES

Departing employees, especially officers and directors, should be concerned about breaching their fiduciary duties to their employer if for nothing else, the large amount of damages that can be awarded against them and the effects of an injunction prohibiting business in competition with their former employer. The assessment of damages by a trial court sitting without a jury, as many breach of fiduciary duty cases are tried, will not be set aside unless manifestly erroneous. *Vendo Co. v Stoner* (supra). Further, Illinois law permits a complete forfeiture of any salary paid by an employer to its fiduciary during a time when the fiduciary was breaching this duty to the employer. *Levy v Markal Sales Corp.*, 268 Ill App 3d 355, 643 NE2d 1206, 204 Ill Dec 599 (1st Dist 1994).

In the *Veco* case previously cited, the court ruled the employer was entitled to recover the total compensation paid to the breaching employees/officers during the time period they were breaching their fiduciary duties owed the employer. Further, the reviewing court indicated that evidence should be taken to impose a constructive trust on the commissions received by the officers/employees' new business firm, the accounts they obtained from pre-termination solicitations. Further, on remand, the defendants would be subject to lost profits of the employer due to the injury to the employer's business from the actions of the departing employees, plus punitive damages and attorneys fees.

Similarly, in the *Everen Securities, Inc. v A.G. Edwards & Sons, Inc.* (supra) case, the court refused to overturn the arbitrator's award to the company of \$1,131,000 for lost profits due to the officers' breach of fiduciary duties for the three years after the officers departed,

plus a terminable years' calculation based on the present value of future years' losses, as well as \$33,000 of forum fees.

In *Dowd & Dowd, Ltd. v Gleason* (supra), the departing law partners found liable for breaching their fiduciary duties to the firm were assessed \$2,464,889.46 for compensation and bonuses paid to them while they were breaching their fiduciary duties, plus two years' lost profits resulting from injury they caused the firm.

CONCLUSION

With the potential of recovering or losing compensation during the period an officer or employee breaches his fiduciary duties to his employer, plus lost profits caused to the employer, and, where there are aggravating circumstances, punitive damages, court costs and attorneys fees, it is incumbent on parties to carefully assess a departing employees' fiduciary duties. It appears from the foregoing analysis of Illinois cases, that employees can (1) locate office space, (2) order office equipment and systems, (3) organize the new business entity to compete after termination with the employer, and (4) use non-confidential, non-protected information not marked confidential, the subject of a confidentiality agreement, or not treated as confidential by an employer, in their new venture. Further, following termination the former employees are free to compete with the former employer. However, where there is in place a valid and enforceable restrictive covenant prohibiting competition for a lawful period, the former employee must refrain from such competition. They also cannot engage in pre-termination solicitation of the employer's customers or in activities to defraud or injure the employer's business.

Officers and directors have heightened fiduciary duties to their employer to consider. They cannot without liability (1) solicit the business of the employer's customers before they leave, (2) fail to disclose they (or their employees) are forming a rival company, (3) use the company's facilities or equipment to assist in developing their new business, (4) solicit fellow employees to join a rival business, (5) orchestrate a mass exodus of employees needed to carry on the employer's business, (6) destroy the company's records needed to conduct its business, (7) convert the company's assets for use in their new business, or (8) fail to act in the company's best interests in dealing with customers or opportunities properly belonging to the company. These actions have been uniformly found to exploit their officer's position to the detriment of their employer or to hinder the employer's ability to continue its business. Otherwise, they may very well be liable for corporate misconduct and subject to substantial damage awards and injunctions prohibiting competition with the former employer.

The foregoing article represents only the opinion of its authors, and may not be relied upon as legal advice to clients or others. Readers are encouraged to perform their own research and prepare their own advice.

Biographies

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