The Ancient Common Law Faithless Servant Rule: Still Relevant in New York

The doctrine that faithless servants paid on a "task-by-task" basis need only to forfeit their salary relating to disloyal activities initially developed in federal courts interpreting New York law.

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An ancient common law doctrine of agency law – the faithless servant doctrine – is still alive and well in the First Department. The rule – which provides that an employee who acts unfaithfully towards his or her employer may be liable to forfeit all compensation earned during the period of unfaithfulness – was recently applied by the First Department in *Mahn v. Major, Lindsey, & Africa, LLC*, Nos. 653048/2014, 155645/2014, 2018 N.Y. App. Div. LEXIS 1713 (1st Dep't Mar. 20, 2018), a case involving a legal recruiter accused of disseminating proprietary information to competitors in return for kickbacks. *Mahn* raises an important issue that the First Department did not directly address: whether or not a "faithless servant" may keep compensation relating to actions that were not found to be disloyal.

The faithless servant doctrine, sometimes described as the "faithless agent doctrine," dates back hundreds of years. In *Murray v. Beard*, 102 N.Y. 505, 508 (1886), the Court of Appeals explained that "[a]n agent is held to *uberrima fides* [good faith] in his dealings with his principal, and if he acts adversely to his employer in any part of the transaction, or omits to disclose any interest which would naturally influence his conduct in dealing with the subject of the employment, it amounts to such a fraud upon the principal, as to forfeit any right to compensation for services." *See also Feiger v. Iral Jewelry, Ltd.*, 41 N.Y.2d 928, 928 (1977) ("One who owes a duty of fidelity to a principal and who is faithless in the performance of his services is generally disentitled to recover his compensation, whether commissions or salary.") (citation omitted); *Consol. Edison Co. v. Zebler*, 40 Misc. 3d 1230(A), 1230(A) (Sup. Ct. N.Y. Cty. 2013) ("Under the faithless servant doctrine, the act of being disloyal to one's employer is itself sufficient grounds for disgorging all compensation received during the period of disloyalty, and does not depend on actual harm to the employer"). It does not "make any difference that the services were beneficial to the principal, or that the principal suffered no provable damage as a result of the breach of fidelity by the agent." *Feiger*, 41 N.Y.2d at 928-29 (citations omitted).

In *Mahn v. Major, Lindsey, & Africa, LLC*, plaintiff Sharon Mahn ("Mahn") was a legal recruiter for the legal recruiting firm Major, Lindsey and Africa, LLC ("MLA") and signed an employment agreement in 2005. In 2009, MLA fired Mahn for allegedly disclosing proprietary information to MLA's competitors. According to MLA, from the beginning of her employment with MLA, Mahn routinely accessed a proprietary internal database and disseminated information to individuals at competing legal recruiting firms. For example, Mahn allegedly assisted her competitors in

placing attorneys that were working with MLA, and even coached the competitors in how to sever the attorneys' relationships with MLA. In return for her help, Mahn allegedly received kickbacks from the competitors. Mahn argued that she was merely cooperating and exchanging information with competitors on potential "leads," which is mutually beneficial, is common in the legal recruiting industry, was known to MLA, and was profitable for MLA. She characterized the alleged "kickbacks" as "fee sharing." After firing Mahn, MLA commenced an arbitration in 2010 with the American Arbitration Association, as required by the arbitration clause in the employment agreement. The arbitrator ultimately issued an award in MLA's favor. Among other things, the arbitrator's decision held that Mahn was a "faithless servant" and accordingly MLA was entitled to recover from Mahn all compensation and commissions that it paid to Mahn while she was employed by MLA.

Mahn Claimed Arbitrator Exceeded Her Power

Mahn petitioned the Supreme Court, New York County, seeking to vacate the arbitration award on several grounds, including that the arbitrator exceeded her power in finding that Mahn was a "faithless servant" and ruling that Mahn should forfeit all her compensation and commissions. MLA cross-moved to confirm the arbitration award.

In a decision dated May 26, 2015, Justice Manuel J. Mendez rejected Mahn's petition and granted the cross-motion to confirm the arbitration award. Justice Mendez explained that Mahn had not stated an adequate basis for vacatur of the award, because there was no evidence of misconduct, fraud, or partiality. There was also no evidence that the arbitrator exceeded her powers.

Mahn appealed Justice Mendez's decision, but the First Department affirmed. The First Department found that the "arbitrator did not exceed her power in finding that [Mahn] was a faithless servant." *Mahn*, 2018 N.Y. App. Div. LEXIS 1713, at *1. The court added that the disgorgement of all of Mahn's past salary and commissions did not violate public policy and was not punitive in nature. *Id.* at *1-2.

An important issue that the parties addressed during briefing is whether or not a faithless servant must disgorge *all* compensation earned from his or her employer during the disloyal periods, or just the compensation related to the employee's faithless actions. Mahn argued that she should not have to disgorge salary and commissions stemming from "loyal" behavior, i.e., attorney placements that she made for MLA.

Mahn argued that under New York law, if an employee's compensation is "task-based," a faithless servant should not forfeit compensation relating to those "tasks" for which the employee was not disloyal. Mahn claimed that her salary was "task-based" because she earned commissions by placing lawyers with law firms. Although she received a monthly stipend from MLA, she argued that this income was a "draw," or an advance on future commissions.

The doctrine that faithless servants paid on a "task-by-task" basis need only to forfeit their salary relating to disloyal activities initially developed in federal courts interpreting New York law, such as *Musico v. Champion Credit Corp.*, 764 F.2d 102 (2d Cir. 1985). In *Musico*, the Second Circuit explained that the original rule in New York was that a faithless servant must forfeit all compensation throughout that employee's period of employment, but that the rule had been relaxed in New York with respect to time periods; if it could be established that a faithless servant was faithless in one time period but faithful for another time period, more recent case law said that the faithless servant should forfeit compensation only for the time period in which the employee was unfaithful. *Id.* at 112-13. The Second Circuit then noted that the Restatement (Second) of Agency called for apportionment of a faithless servant's compensation on both a task-by-task and time period basis. *Id.* at 113.

The *Musico* court admitted that the Restatement went further than then-current New York case law (which apportioned a faithless servant's compensation by time period only). *Id.* But the Second Circuit believed that New York state courts would adopt the Restatement rule because "no modern New York case specifically and unambiguously rules out apportionment corresponding to completion of specified tasks, and we see no principled basis for applying different rules to the two situations." *Id.* The *Musico* court thus held that even during a time period in which an employee is "faithless," that employee's compensation may be apportioned between loyal tasks and disloyal tasks if "the parties have apportioned various agency tasks under a number of separate agreements, where the agents engaged in no misconduct at all in carrying out the specific tasks set out in two of those agreements, and where the agents' misdealing with respect to one task has neither tainted nor interfered with the completion of the other tasks." *Id.* at 14. The Second Circuit also reasoned that its conclusion was consistent with a 1944 Second Circuit case, *Trounstine v. Bauer, Pogue & Co.*, 144 F.2d 379 (2d Cir. 1944), in which the Second Circuit apportioned an employee's salary because "the breach of duty . . . did not taint all dealings." *Musico*, 764 F.2d at 114. Turning to the facts of the case, the Second Circuit in *Musico* concluded that "where the parties have apportioned various agency tasks under a number of separate agreements, where the agents engaged in no misconduct at all in carrying out the specific tasks set out in two of those agreements, and where the agents' misdealing with respect to one task has neither tainted nor interfered with the completion of the other tasks . . . New York law, like the *Restatement*, requires us to apportion any forfeited compensation."

Second Circuit Reaffirms but Phrases Test Differently

The Second Circuit reaffirmed this position in *Phansalkar v. Andersen Weinroth & Co., L.P.*, 344 F.3d 184 (2d Cir. 2003) but phrased the test a bit differently. In *Phansalkar*, the Second Circuit held that an employee may "keep compensation for the *tasks* he performed loyally, during the time period in which he was disloyal in other work" if "(1) the parties had agreed that the agent will be paid on a task-by-task basis (*e.g.*, a commission on each sale arranged by the agent), (2) the agent engaged in no misconduct at all with respect to certain tasks, and (3) the agent's disloyalty with respect to other tasks neither tainted nor interfered with the completion of the

tasks as to which the agent was loyal." *Id.* at 205 (citation and internal quotation marks omitted, emphasis in original). The Second Circuit added that "where these three criteria are met, a disloyal employee forfeits only compensation earned in connection with the specific tasks as to which he was disloyal; he retains compensation earned in connection with the specific tasks as to which he was loyal." *Id.*

Sandrino v. Michaelson Assocs., LLC, No. 10 Civ. 7897 (BSJ), 2012 U.S. Dist. LEXIS 165143 (S.D.N.Y. Nov. 19, 2012) is an example of a federal court following the *Phansalkar* test and apportioning a faithless servant's compensation on a task-by-task basis. In *Sandrino*, the plaintiff Sandrino was a legal recruiter for the defendant Michaelson Associates ("MA"). Her agreement with MA labeled her as a "contractor" and she was paid on commission and via a bi-weekly "draw" against future commissions. Sandrino began having discussions about joining a rival recruiting firm, the Lucas Group ("Lucas"). Subsequently, while still employed by MA, Sandrino informed Lucas of law firm opportunities, referred a lawyer to Lucas and disclosed to Lucas various candidates that had not been successfully placed by MA. Sandrino then accepted a position with Lucas. MA found out and fired Sandrino at the same time that Sandrino made a placement for one of MA's clients, for which MA received a large commission. MA refused to pay Sandrino her share of that commission, arguing that she was a "faithless servant" and thus was not entitled to any compensation. Sandrino sued and the parties both moved for summary judgment on Sandrino's breach of contract claim. The SDNY, in an opinion by Judge Barbara Jones, held that under the faithless servant doctrine, Sandrino did not have to forfeit her commission for the placement made for MA even though she may have been "faithless" during that time period. *Id.* at *23-24. The court explained that Sandrino was paid on a task-by-task commission basis and under New York law, disloyal employees paid on a task-by-task basis may retain compensation for loyal acts. *Id.* Sandrino's disloyal actions had nothing to do with the placement in question. *Id.* at *24.

There are fewer cases in New York State court analyzing the issue of apportioning a faithless servant's compensation by task. In *G.K. Alan Assoc., Inc. v. Lazzari*, 44 A.D. 3d 95, 104 (2d Dep't 2007), the Second Department stated that as of the date of the decision (July 10, 2007), no New York state appellate court had analyzed the issue of apportioning a disloyal employee's salary on a task-by-task basis. The Second Department adopted the *Phansalkar* rule, explaining that "[s]ince forfeiture arises upon misconduct and disloyalty which substantially affect the contract of employment and is required only upon a persistent pattern of disloyalty, it follows that obligations that are unrelated to the disloyalty would not be affected by it." *Id.* (internal citations and quotation marks omitted).

The Third Department confronted the same issue in 2016. In *City of Binghamton v. Whalen*, 141 A.D.3d 145, 148 (3d Dep't 2016), the defendant engaged in a "persistent pattern of disloyalty" over six years but purportedly exhibited an "exemplary performance of his duties when he was not stealing from plaintiff." The Third Department noted that *G.K. Alan* and federal decisions such as *Phansalkar* had recognized apportionment of forfeiture of compensation to the specific tasks as to which the defendant was disloyal. *Id.* However, the Third Department distinguished

those cases on their facts, holding that "apportioning the amount of compensation to be forfeited under the faithless servant doctrine has been limited to circumstances where, unlike here, the employee or agent is compensated on a task-by-task basis." *Id.* Because the defendant in *Binghamton* was paid on a salary, the Third Department determined that he was not paid on a task-by-task basis and "decline[d] to relax the faithless servant doctrine so as to limit plaintiff's forfeiture of all compensation earned by defendant during the period in which he was disloyal." *Id.* at 149.

Research has not uncovered a Court of Appeals, First Department, or Fourth Department case directly addressing the *Phansalkar* test of apportioning a faithless servant's compensation if that employee is paid on a task-by-task basis. But there is at least one Supreme Court case that follows *Phansalkar*. *See, e.g.*, *Schneider v. Wien & Malkin LLP*, 5 Misc. 3d 1011(A), 1011(A) (Sup. Ct. N.Y. Cty. 2004) (in a decision by Justice Marcy S. Friedman, finding that the "*Musico* test is consistent with New York law, and sets forth viable criteria for determining whether apportionment should be made" and holding that there was a "clear basis for apportioning fees as between supervisory fees, which included services as to which there was disloyalty, and other fees as to which there was not").

Mahn Argues She Was Paid by the Task

In *Mahn*, Mahn argued that she was paid on a task-by-task basis, and as such, under the *Phansalkar* test adopted by the Second Department in *G.K. Alan*, even if Mahn was a "faithless servant," she should not have to forfeit commissions unrelated to the disloyal behavior. Mahn stated that she had placed numerous attorneys for MLA for which she should be able to retain her commissions. Mahn also argued that *Sandrino* – in which a faithless legal recruiter was permitted to retain commissions for "loyal" placements – was directly on point. In response, MLA argued that there was no governing New York law requiring the arbitrator to apportion Mahn's commissions between loyal and disloyal acts (because the Court of Appeals has never addressed the issue). MLA also distinguished cases like *Sandrino* (a case that Mahn apparently never cited to the arbitrator) by arguing that Mahn was a salaried employee, not an independent contractor, and was thus not paid on a task-by-task basis. MLA asserted that an arbitration award can only be overturned where the arbitrator barely offers a colorable justification for the decision, and the arbitrator in this case provided a well-grounded one.

In *Mahn*, even though Mahn asked the First Department to consider apportionment of her salary on a task-by-task basis, the First Department's decision does not directly address this issue. The court found that the "disgorgement of [Mahn's] past salary and commissions" was not violative of public policy or punitive, *Mahn*, 2018 N.Y. App. Div. LEXIS 1713, at *1-2, but the First Department did not address or cite *Phansalkar*, *G.K. Alan*, or any other case involving the apportionment of a faithless servant's salary if that employee is paid on a task-by-task basis.

The fact that the First Department declined to apportion Mahn's salary on a task-by-task basis could constitute a *sub silentio* departure from the Second Circuit's rule. However, without

further guidance from the First Department or the Court of Appeals, faithless servants and their employers will not know for certain the amount of compensation that such employees must forfeit.

We believe that New York appellate courts should proceed cautiously before adopting the task-by-task apportionment methodology that has gained prominence in the Second Circuit and even in the Restatement. The task-by-task approach is less practical and more difficult to apply. Employers use many different compensation models, and it is not always clear whether an employee is paid by salary or by task, or by some hybrid of the two. If the rule requires a clear binary distinction, it will be difficult for courts to decide which employees are paid on a task-by-task basis and which employees are not. The goal should be consistency and less uncertainty in awarding damages. Further, the approach would lead to unfair results whereby two faithless servants who engaged in the exact same disloyal behavior would forfeit different amounts of compensation if one is paid on salary and the other is paid on commission. A blanket rule requiring a faithless servant to forfeit all compensation during the faithless period – even if that employee is paid on a task-by-task basis – is the sounder approach and more in line with the Court of Appeals authority set forth in *Murray* and *Feiger*.

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