

A California Employee's Duty of Loyalty

In California, an employee owes his or her employer an undivided duty of loyalty. An employee, while employed, cannot act to the detriment of his or her employer. For example, an employee may not compete with his or her employer in areas connected to his employment. This article summarizes the current state of California law with respect to this duty of loyalty and possible redresses for an employee's breach of that duty.

Termination for Cause

An employer may terminate for cause an employee who breaches his or her duty of loyalty even where that breach does not rise to the level of a tortious claim.¹ In *Stokes v. Dole Nut Co.*, two employees were terminated for cause after their employer learned that they were actively attempting to establish a business that would compete directly against their employer.² Although case law supports the claim that an employee may make preparations to compete before resigning as an employee (here the plaintiffs had not actually competed with their employer),³ the court distinguished between conduct that would give rise to a tortious action and conduct that would constitute cause for termination.⁴ The court concluded that the employer's right to an undivided loyalty becomes compromised once the employee's outside activities give rise to the potential of personal influences.⁵ The company need not wait until it is actually harmed.⁶ Furthermore, the court observed that appropriate deference to the exercise of managerial discretion should be afforded the employer when evaluating whether the employee's disloyal conduct warranted termination.⁷

Tortious Claim for Breach of the Employee's Duty of Loyalty

For a tortious claim, the elements of a cause of action for breach of a duty of loyalty, are: "(1) the existence of a duty; (2) a breach of that duty; and (3) damages proximately caused by that breach."⁸ The employer must establish each of these elements in order to prevail in its claim. Each of these elements is discussed separately below.

Existence of a Duty

¹ *Stokes v. Dole Nut Co.* (1995) 41 Cal.App.4th 285, 295-96 [48 Cal.Rptr.2d 673].

² *Ibid* at p. 293.

³ *Ibid* at pp. 293-94; also *Bancroft-Whitney Co. v. Glen* (1966) 64 Cal. 2d 327 [49 Cal. Rptr. 825, 411 P.2d 921].

⁴ *Stokes*, 41 Cal.App.4th at p. 294.

⁵ *Ibid* at p. 295-96.

⁶ *Ibid*.

⁷ *Ibid*.

⁸ *Huong Que, Inc. v. Luu* (2007) 150 Cal.App.4th 400, 410 [58 Cal.Rptr.3d 527].

The employee's duty of loyalty arises not by employment contract but from the relationship of principal and agent where the agent owes a fiduciary duty to act loyally for the principal's benefit in any matter connected with the agency relationship.⁹ An employee acts as an agent of his employer and, as such, owes an undivided loyalty to his employer.¹⁰ However, at least one Federal court concluded that there is no independent cause of action for breach of a duty of loyalty by employees under California law – the duty of loyalty arises out of an employee's fiduciary duties.¹¹ The federal court then concluded that the employee defendants, three seamstresses and an intern, were not fiduciaries and, thus, owed no duty of loyalty to their employer.¹² Subsequently, a second Federal court concluded that California does recognize a cause of action for an employee's breach of his or her duty of loyalty at least where the employee had been entrusted with managerial duties.¹³ Thus an employee's position at a company may impact whether there exists a duty of loyalty sufficient to support a tortious cause of action, but courts should recognize such a duty at least where the employee holds a high level managerial position.¹⁴

Breach

An employee breaches his or her duty of loyalty and that breach can give rise to a cause of action when "the employee takes action which is inimical to the best interests of the employer."¹⁵ The duty of loyalty is breached once the employee's actions are detrimental to the employer.¹⁶ The employee's duty of loyalty encompasses:

- A duty to refrain from competing with the employer or assisting its competitors.¹⁷,
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- A duty not to use for his own purpose, or communicate to a third party for its use, the employer's confidential information.¹⁹

⁹ *Ibid* at p. 411-12.

¹⁰ *Ibid* at p. 414.

¹¹ *Mattel, Inc. v. MGA Entertainment, Inc.*, 2011 U.S. Dist. LEXIS 55756, 19-20 (C.D. Cal. March 28, 2011).

¹² *Ibid* at 20.

¹³ *Integral Dev. Corp. v. Tolat*, 2013 U.S. Dist. LEXIS 153705, 9 (N.D. Cal. Oct. 25, 2013).

¹⁴ *See Mattel*, 2011 U.S. Dist. LEXIS 55756 at p. 3 (no duty imposed for seamstresses); *Stokes*, 41 Cal.App.4th at p. 288-89 (duty imposed for salaried production supervisor and salaried shift manager); *Huong Que*, 150 Cal.App.4th at p. 414 (duty imposed for managing agent); *Fowler v. Varian Assocs.* (1987) 196 Cal.App.3d 34, 36 [241 Cal.Rptr. 539], 37 (duty imposed for marketing manager).

¹⁵ *Huong Que*, 150 Cal.App.4th at p. 414.

¹⁶ *Ibid*.

¹⁷ *Ibid* at p. 416.

¹⁸ *Ibid* at p. 413.

¹⁹ *Ibid* at p. 416.

However,

- An employee is permitted to make preparations to compete before resigning as an employee²⁰ and there is no duty to disclose such preparations unless nondisclosure itself is harmful to the company.²¹
- The formation of a potentially competing company does not necessarily breach the employee's duty of loyalty.²²

Damages

One measure of damages for the breach of an employee's duty of loyalty is the disgorgement of his or her wages.²³ This would include wages paid while the employee was breaching his duty of loyalty, even where paid for work properly performed.²⁴ Such disgorgement is possible even where the employer cannot establish that it was actually harmed by the employee's conduct.²⁵

Actual damages are also permitted for the breach of an employee's duty of loyalty provided those damages were proximately caused by that breach.²⁶ However, the employer cannot recover damages based upon speculation or the possibility that the wrongful conduct of the employee caused the harm.²⁷ The employer must show that the employee's wrongful conduct was a substantial factor in bringing about the harm to the employer.²⁸

Finally, punitive damages may be possible if the employee's conduct is egregious.²⁹

Attorney Fees Provisions

Under California's Code of Civil Procedure section 1021, if there is no statute or contract to the contrary, the parties to a suit pay their own fees. However, California does have a strong public policy favoring the indemnification and defense of employees for claims and

²⁰ *Ibid* at p. 414.

²¹ *Bancroft-Whitney Co. v. Glen* (1966) 64 Cal.2d 327, 346-47 [49 Cal.Rptr. 825, 411 P.2d 921].

²² *Mamou v. Trendwest Resorts, Inc.* (2008) 165 Cal.App.4th 686, 719-20 [81 Cal.Rptr.3d 406].

²³ *Service Employees Internat. Union, Local 250 v. Colcord* (2008) 160 Cal.App.4th 362, 371 [72 Cal.Rptr.3d 763].

²⁴ *J. C. Peacock v. Hasko* (1961) 196 Cal.App.2d 353, 358.

²⁵ *Ibid*.

²⁶ See *Service Employees Internat. Union, Local*, 160 Cal.App.4th at pp. 372-74.

²⁷ *Ibid* at p. 375.

²⁸ *Ibid*.

²⁹ *Ibid*.

liabilities resulting from the employees' acts within the course and scope of their employment.³⁰

For example, California Labor Code section 2802 provides that “[a]n employer shall indemnify his or her employee for all necessary expenditures or losses incurred by the employee in direct consequence of the discharge of his or her duties, or of his or her obedience to the directions of the employer, even though unlawful, unless the employee, at the time of obeying the directions, believed them to be unlawful.” However, this provision applies to third party claims and does not apply to disputes between an employee and an employer.³¹

Additionally, California Corporations Code section 317 subdivision (d) provides that a corporation **must** indemnify an employee if he has been successful on the merits in defense of an action arising out of the performance of his corporate duties.³² This does include disputes between an employee and employer.³³ However, indemnification under this statute applies only where an action has been brought against an employee for conduct performed in connection with his corporate duties – it would not apply to conduct where the employee sought to promote his own interest as such conduct would be outside the scope of his or her employment.³⁴ However the provision would apply if the cause of action against the employee were for negligence rather than for a breach of his or her duty of loyalty (e.g., asserting that an employee failed to perform his or her duties competently due to the employee’s divided loyalties), allowing the employee to recover attorney fees if he or she were successful on the merits for such a claim.³⁵

Conclusion

Where an employee’s conduct creates a potential conflict of interest between the employee and his or her employer, the employee may be terminated for cause even where the employer has not yet been harmed by the conduct. However, to prevail in a cause of action for the breach of an employee’s duty of loyalty, the employee most likely should be in a managerial position and the employee’s conduct must have been in detriment to the employer. In such cases, disgorgement of the employee’s wages is one measure of damages even where the employer cannot establish that it was harmed. Where the employer can establish that the employee’s disloyal conduct was the proximate cause of harm suffered by

³⁰ *Nicholas Laboratories, LLC v. Chen* (2011) 199 Cal.App.4th 1240, 1247 [132 Cal.Rptr.3d 223].

³¹ *Ibid* at p. 1251.

³² *Plate v. Sun-Diamond Growers* (1990) 225 Cal.App.3d 1115, 1128 [275 Cal.Rptr.3d 667].

³³ *Nicholas Laboratories* at p. 1252.

³⁴ *Wilshire-Doheny Associates, Ltd. v. Shapiro* (2000) 83 Cal.App.4th 1380, 1389 [100 Cal.Rptr.2d 478].

³⁵ See *Plate*, 225 Cal.App.3d at pp. 1124-1125.

the employer, the employer can recover actual damages. Additionally, where the employee's conduct is egregious, punitive damages are possible. Finally, even where the employer is unsuccessful in a claim for breach of the duty of loyalty, the employer would not be liable for the employee's attorney fees if the conduct complained of was not within the scope of his or her employment.

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