TRIAL.COM
THE NETWORK OF TRIAL LAW FIRMS

Windy City Litigation Management

PREDATORY RAIDING AND HIGH-END EXECUTIVE DEFECTIONS

Joel Hoxie
Snell & Wilmer

PREDATORY RAIDING OF A COMPETITOR'S TOP-LEVEL TALENT AND REMEDIES POTENTIALLY AVAILABLE TO THE VICTIMS OF SUCH RAIDING, INCLUDING CLAIMS AGAINST DEFECTING EXECUTIVES IN THE ABSENCE OF A NON-COMPETE

* * *

Joel P. Hoxie
Andrew C. Stone
Snell & Wilmer L.L.P.
www.swlaw.com

I. INTRODUCTION

Departing executives and the competitors that covet them sometimes fail to recognize or fully understand the legal duties such executives owe to their current employers, apart from or even in the absence of formal employment agreements containing customary non-competition, non-solicitation, and confidentiality provisions. In today's tough business climate, where companies vigorously compete with each other for executive talent—and the opportunities for increased market share these executives bring to the table—it is important that corporate counsel for both the former and new employer understand what conduct the law generally permits, and what conduct crosses the line, when executives are recruited away by the competition. This article briefly discusses the applicable legal principles, the pitfalls such overzealous raiding can pose for companies seeking a competitive edge, and then offers suggestions that may prove helpful to counsel on both sides of the issues.

II. DEPARTING EXECUTIVES

Executives owe, as a matter of law, a fiduciary duty of loyalty to their employers. This duty does not diminish just because an executive has decided to jump ship and go to work for a competitor.

a. Prohibited Activities

An executive may not compete with his employer concerning the subject matter of the employment. *See Restatement (Second) of Agency* § 393 (1958). However, an executive may "make arrangements to compete." *See id*. at cmt. e. The question, therefore, becomes whether the executive's actions constituted a breach of his fiduciary duty or "were merely legally permissible preparations to compete." *See Security Title Agency, Inc. v. Pope*, 219 Ariz. 480, 492, 200 P.3d 977, 989 (Ariz. Ct. App. 2008) (quoting *Jet Courier Serv., Inc. v. Mulei*, 771 P.2d

486, 493 (Colo. 1989)). "The line separating mere preparation from active competition may be difficult to discern in some cases." *See id*. In determining whether a fiduciary duty breach has occurred, courts will focus on the nature of the defendant's preparations to compete. *See Bancroft-Whitney Co. v. Glen*, 64 Cal.2d 327, 345, 411 P.2d 921, 935 (Cal. 1966).

An executive or manager who has decided to move to a competitor breaches his duty of loyalty if he solicits, while still employed, his fellow co-workers to leave their current positions to work for a competing enterprise. *See Restatement (Second) of Agency* § 393 cmt. e. Courts recognize, however, that "[t]he limits of proper conduct with reference to securing the services of fellow employees are not well marked." *See id*. For example, there is a distinction between a manager or executive "encouraging or inducing her employees to terminate their employment and join a competing company" and simply providing the rival employer's contact information to fellow employees. *Compare Bancroft*, 49 Cal.Rptr. at 840, 411 P.2d at 936; *with Motorola, Inc. v. Fairchild Camera & Instrument Corp*., 366 F. Supp. 1173, 1177 (D. Ariz. 1973).

In determining whether an executive has impermissibly solicited co-workers, courts will "consider the nature of the employment relationship, the impact or potential impact of the employee's actions on the employer's operations, and the extent of any benefits promised or inducements made to co-workers to obtain their services for . . . the competing enterprise." *See Pope*, 219 Ariz. at 493, 200 P.3d at 990; *Jet Courier*, 771 P.2d at 497. No single factor is dispositive. *See id*. Employees in "key management" positions, however, may not actively promote the interests of the competing firm while still employed by an employer. *See ABC Trans Nat'l Transp., Inc. v. Aeronautices Forwarders, Inc.*, 90 Ill.App.3d 817, 825, 413 N.E.2d 1299, 1306 (Ill. App. Ct. 1980).

An executive or senior-level manager also is not entitled to "solicit customers for such rival business before the end of his employment nor can he properly do other similar acts in direct competition with the employer's business." *See Restatement (Second) of Agency* § 393 cmt. e. An executive who is making preparations to compete after termination of his employment is permitted to advise current customers that he is leaving. *See McCallister Co.*, *v. Kastella*, 170 Ariz. 455, 459, 825 P.2d 980, 984 (Ariz. Ct. App. 1992) (citing *Evans v. Valley Radiologists, Ltd.*, 127 Ariz. 177, 619 P.2d 5 (Ariz. 1980); *Crane Co. v. Dahle*, 576 P.2d 870 (Utah 1978)). However, any "pre-termination solicitation" of those customers for a new competing business violates an employee's duty of loyalty. *Jet Courier*, 771 P.2d at 494. The line between acts by an executive that constitute prohibited "solicitation" and acts that constitute permissible "preparation" is not precise. *See Rehabilitation Specialists, Inc. v. Koering*, 404 N.W.2d 301, 305 (Minn. Ct. App. 1987). For example, even if an executive did not solicit customers, but simply

"discussed her intention to leave" with customers, she could be held liable for a breach of loyalty to her employer. *See id.*

Further, many jurisdictions have held that an executive's taking of legally protected information from his or her employer, in order to seek a competitive advantage upon resignation, constitutes a breach of the duty of loyalty. *See, e.g., Abbot Redmont Thinlite Corp. v. Redmont*, 475 F.2d 85, 89 (2d Cir. 1973) (stating that employee cannot "utilize specific information he obtained during his employment to deprive ex-employer of customers with whom he knows a deal is in the process of completion"); *Tlapek v. Chevron Oil Co.*, 407 F.2d 1129, 1133 (8th Cir. 1969) (finding that employee has duty not to use confidential information acquired in course of employment for own benefit and to detriment of former employer); *Bull v. Logetronics, Inc.*, 323 F. Supp. 115, 133 (E.D. Va. 1971) (stating that employee's duty "does not cease when employment ends. He has a duty not to reveal confidential information obtained through his employment, and not to use such confidential information after he has left his employment."); *United Ins. Co. of Am. v. Dienno*, 248 F. Supp. 553, 557 (E.D. Pa. 1965) (stating party who develops or possesses confidential information belonging to his employer should not be allowed to terminate his association and then use information to undercut former employer).

b. Remedies Available to Current Employers

An employer that has suffered loss due to the wrongful conduct of a departing executive has several potential legal remedies at its disposal. In addition to suing the departing executive for money damages for breach of the duty of loyalty, the employer may have a claim against its competitor for aiding and abetting a breach of fiduciary duty.[1] Two other potential remedies include pursuing a Uniform Trade Secrets Act claim and pursuing a claim for tortious interference with contract.

1. Uniform Trade Secrets Act

The Uniform Trade Secrets Act protects employers from the unauthorized use or disclosure of information from which the company derives economic value and has made reasonable efforts to maintain its secrecy. *See* U.T.S.A. § 1. The Uniform Trade Secrets Act has been adopted in forty-five states. The term "trade secrets" refers to information including "a formula, pattern, compilation, program device, method, technique, or process" that has been kept confidential and is not known to the competition. *See id*. at § 1(4). Trade secrets differ from other undisclosed information in a business in that "it is not simply information as to single or ephemeral events." *See Restatement (First) of Torts* § 757 cmt. b. (1939). Rather, "[a] trade secret is a process or device for continuous use in the operation of business" that may relate to:

[1] This claim is addressed in detail in Section III below.

"rebates or other concessions in a price list . . . a list of specialized customers, or a method of bookkeeping or other office management." *See id*.

A company that has suffered an unauthorized disclosure of a trade secret or had its trade secrets acquired improperly is entitled to injunctive relief. *See* U.T.S.A. § 2. In addition, the former employer is entitled to recover damages for the actual loss caused by a defecting executive's misappropriation of trade secrets or proprietary information and the unjust enrichment that is not taken into account in computing the actual loss. *See id*. at § 3(a). If "willful and malicious misappropriation" occurred, then the former employer may be entitled to an exemplary award for double its damages. *See id*. at § 3(b).

2. Tortious Interference with Contract

If the defecting executive's conduct occurred while he was still on the payroll, and the conduct caused the loss of existing customer contracts, a claim for tortious interference with contract may be pursued. The elements for this claim are generally similar from state to state. By way of example, in Arizona the elements of tortious interference with contract are: (1) existence of a contractual relationship, (2) knowledge of the relationship on the part of the interferor, (3) intentional interference inducing or causing breach, (4) resultant damage to the party whose relationship has been disrupted, and (5) that the defendant acted improperly. *See Wells Fargo Bank v. Arizona Laborers, Teamsters and Cement Masons Local No. 395 Pension Trust Fund*, 201 Ariz. 474, 493, 38 P.3d 12, 31 (Ariz. 2002).

III. PREDATORY RAIDING

Many companies engage in lateral recruiting. A company that crosses the line in its zeal to poach executives or key managers from its competitors, however, may find itself exposed to substantial liability. A recent case highlights the potential adverse consequences stemming from an overzealous raid on a competitor's stable of talent and customer base.

a. *Security Title Agency v. Pope*

In *Security Title Agency, Inc. v. Pope*, 219 Ariz. 480, 200 P.3d 977 (Ariz. Ct. App. 2008), Security Title sued rival title company First American Title in connection with First American's recruitment of Linda Pope, a key Security Title manager and assistant vice president. In furtherance of its goal to regain the top position in the title insurance industry that it had lost to Security Title in 2000, First American, in 2003, created a new division, "the Talon Group," that would offer traditional title insurance customers and agents a new competitive brand. Talon's strategy was to operate only in the top real estate markets and only in segments where it could quickly establish market share and profitability. Its business strategy depended heavily on the

recruitment of key people who had relationships with key customers and other key employees. *Id*. at 484-485, 200 P.3d at 981-982.

A senior vice president at Talon, James Clifford, targeted Linda Pope as one such key recruit. Pope managed a Security Title office in the Phoenix metropolitan area that was one of the largest and most successful title insurance branches in the industry. *Id*. Clifford met with Pope and learned in his first meeting with her that the branch Pope managed had annual revenues of $8 million. Clifford expressed his desire that Pope and most of the employees from her branch leave Security Title to come work for First American's Talon Group. *Id*.

After meeting with Clifford, Pope agreed to leave Security Title for First American. Shortly thereafter, Pope arranged for Clifford to meet individually with four of her senior reports, including three department heads and the branch's marketing director. Pope attended all but one of these meetings. At one such meeting over drinks and dinner, Pope told one of her department heads, in Clifford's presence, that she was planning on all forty branch employees going with her to Talon.

After getting several key employees to agree to go with her to Talon, Pope called several department-head meetings at which she openly discussed with her department heads her impending move to First American. *See id*. At Pope's direction, one of her department heads located a form to be used by home buyers and sellers to transfer their escrow files from Security Title to Talon. *Id.* at 486, 200 P.3d at 983. At Pope's direction, one department head and five escrow officers prepared forms directing Security Title to transfer escrow files to Talon. At trial, one assistant branch manager at Pope's branch testified that Pope "would try to get us excited and anxious about making the move. She would tell us how much better it was going to be, how much better the computer system would be, the benefits would be. So she, in turn would-kind of recruit [] us." *Id*. at 485-86, 200 P.3d at 982-83.

During the recruiting process, Pope also met with First American's president, Gary Kermott (headquartered in Southern California). When asked at trial about this meeting, Kermott assured the jury that during his meeting with Pope he made clear that "[Pope] should not and it was not First American's policy to recruit others within the company, while she worked for that company." *Id*. at 487, 200 P.3d at 984. When, at her meeting with Kermott, Pope expressed concern that she could get sued for leaving, she was told, "[w]e can't prevent you from being sued." *Id*. That same day, however, Kermott arranged for a conference call with Pope and an outside attorney, who counseled Pope not to tell her subordinates or Security Title's customers that she was leaving prior to her resignation. Concerned that Pope, after the conference call with outside counsel, was becoming "scared . . . into a position where she would just shut down and

not continue discussions," Clifford again spoke with Pope and reassured her that First American would indemnify her "against anything." *Id*. In contemporaneous emails among Talon Group executives, the consensus was that Clifford's conversation with Pope had "repaired the outside counsel damage." *Id*.

Approximately two months after Clifford first met with Pope, thirty-five Security Title employees walked out *en masse* with Pope to join First American. In connection with the walk-out, First American provided each employee with a two-line letter to send to Security Title concerning the conditions under which they had left Security Title, which stated: "[p]ursuant to the ultimatum I received . . . this letter is to confirm my employment was terminated." *Id*. at 489, 200 P.3d at 986. The employees who signed such form letters admitted at deposition or trial that they were false, since none of them had been terminated by Security Title. *Id*.

The mass walk-out left Pope's Security Title branch in a state of "chaos." *Id*. The branch lost approximately seventy percent of its revenue immediately following First American's raid. *Id*.

b. Aiding and Abetting Breach of Fiduciary Duty

Security Title sued Pope for breach of fiduciary duty. Security Title also sued First American for aiding and abetting Pope's breach of fiduciary duty. After a seven-week trial, the jury awarded Security Title $6.3 million in compensatory damages, finding Pope's and First American's relative degrees of fault to be 3.17 percent and 96.83 percent, respectively. *Id*. at 490, 200 P.3d at 987. In addition, the jury awarded Security Title $35.2 million in punitive damages, assessing $35 million against First American and $200,000 against Pope. *Id.*

The Arizona Court of Appeals affirmed the judgment in favor of Security Title, although it reduced the punitive damages award from $35.2M to $6.1M on constitutional grounds. *Id*. at 506, 200 P.3d at 1003. The Court of Appeals rejected First American's argument that the jury instruction on aiding and abetting a breach of fiduciary duty was erroneous and its contention that Pope was merely preparing to compete against Security Title in her dealings with subordinates leading up to the mass walkout two months later. *Id*. at 496-97, 200 P.3d at 993-94.

The foregoing case provides a template for how a company can expose itself to substantial monetary damages when overzealous executives charged with lateral recruiting responsibilities cross the line in a company's quest for increased market share. The *Restatement of Torts (Second*) § 876(b) sets forth the elements of an aiding and abetting claim. "For harm resulting to a third person from the tortious conduct of another, one is subject to liability if he . . . knows the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself." *Id*. As the comments to the *Restatement*

make clear, "[a]dvice or encouragement to act operates as a moral support to a tortfeasor and if the act encouraged is known to be tortious it has the same effect upon the liability of the adviser as participation or physical assistance." *See id*. cmt. d.

Other courts have articulated the elements of the claim as requiring proof that: (1) the primary tortfeasor has committed a tort causing injury to the plaintiff; (2) the defendant knew the primary tortfeasor breached a duty; (3) the defendant substantially assisted or encouraged the primary tortfeasor in the breach; and (4) a causal relationship exists between the assistance or encouragement and the breach. *See Wells Fargo Bank v. Arizona Laborers, Teamsters and Cement Masons Local No. 395 Pension Trust Fund*, 201 Ariz. 474, 485, 38 P.3d 12, 23 (Ariz. 2002). It is important to note that the new employer need not have "actual and complete knowledge" of the primary violation of the departing executive. *See Pope*, 219 Ariz. at 491, 200 P.3d at 988 (quoting *Wells Fargo,* 201 Ariz. at 488, 38 P.3d at 26). Further, the causal connection requires only that the new employer's assistance made it "easier" for the violation to occur, not that the assistance was "necessary." *See Wells Fargo* at 489, 38 P.3d at 27.

The critical lesson from the *Security Title* case is that a company may be held liable in conjunction with recruiting an executive from a competitor, even without a complete understanding or knowledge of the executive's conduct prior to formally resigning. Thus, it is important for companies to act proactively in an attempt to prevent these types of situations from occurring.

c. Protective Policies

Companies should initially determine if a recruited executive is bound by any restrictive agreements with his current employer. Determining up front the existence of any contractual limitations will help an employer weigh the potential risks of recruiting a particular candidate. Moreover, even if the executive is not bound by a nonsolicitation or noncompete agreement, he should be instructed that while he remains on the payroll, he still owes a common law duty of loyalty to his current employer not to misappropriate confidential or proprietary data or to solicit subordinates or customers.

An employer also may consider obtaining a written acknowledgement or certification from the candidate verifying that he has not taken or used any confidential or proprietary information from his current employer. The certification could be used to establish any of the following: the verification is a condition of employment; using the former employer's confidential or proprietary information is prohibited; and/or the executive agrees not to solicit or encourage customers or subordinates to terminate their relationship with the former employer for a specified period of time. Even if such a certification is used, it may not fully insulate the

company from liability. But the use of a certification should impress upon the employee the importance of faithfully discharging the duties owed to his current employer while still on the payroll. Finally, corporate counsel should ensure that the executives who get involved in lateral recruiting on behalf of the company understand the recruiting tactics that are permissible and those that could constitute aiding and abetting breach of fiduciary duty, thus exposing the company to unanticipated liability.

IV. CONCLUSION

The importance of a company's implementation of proper recruiting policies and procedures in its search for top-level lateral executive talent and increased market share cannot be over emphasized. The *Security Title* case is but one example of how an overzealous corporate executive involved in an aggressive recruiting campaign to increase market share through lateral hiring can expose his or her company to substantial liability by encouraging executive recruits to engage in conduct constituting a breach of the fiduciary duty the candidate still owes his current employer. As for the company that falls victim to a competitor's predatory raid on its key executives and customers, case law demonstrates that there are remedies available, even where the defecting executive is not subject to standard non-competition, non-solicitation, or confidentiality agreements.

Joel P. Hoxie

Experience representing clients in all areas of civil litigation, including commercial and professional liability litigation. Emphasis on corporate, securities, banking, unfair competition, contract, business tort, racketeering, and real estate litigation and arbitration.

PROFESSIONAL RECOGNITION AND AWARDS

Named Southwest Super Lawyer by Law & Politics Magazine (2007)

The Best Lawyers in America(R), 2007

EDUCATION

University of Iowa College of Law (J.D., with high distinction, 1978)

Order of the Coif

Princeton University (A.B., Politics, cum laude, 1971)

COURT ADMISSIONS

Supreme Court of Arizona

United States Court of Appeals, Ninth Circuit

United States Court of Appeals, Tenth Circuit

United States District Court, District of Arizona

PROFESSIONAL MEMBERSHIPS AND ACTIVITIES

State Bar of Arizona

American Bar Association

Maricopa County Bar Association

Arizona Bar Foundation, Fellow

Arizona Association of Defense Counsel

Securities Industry Association, Compliance and Legal Division

International Association of Defense Counsel

COMMUNITY INVOLVEMENT

Heard Museum

Life Trustee (2005)

Board of Trustees (1989 - present)

Board of Trustees, President (1995-1997)

Phoenix Country Club

Board of Directors (2000 - present)

Snell & Wilmer L.L.P. LAW OFFICES Character comes through.®