"It's the Sneaking Around that Gets You in Trouble":

The Key to Unlocking Fiduciary Duty Litigation Claims

© Comstock

by Gregory J. Haley

The key to unlocking the door to liability in business dispute litigation, or the means to slam the door shut, lies in the presentation and characterization of breach of fiduciary duty claims. Lawyers and parties sometimes overlook fiduciary duty claims because of the difficulty in defining such claims or listing the required elements of proof. A breach of fiduciary duty claim can be the foundation for other claims based on theories of intentional interference with contractual relationships and business conspiracy. The application of fiduciary duty principles, however, is difficult because the cause of action, like sand, shifts with the changing circumstances of the players.

Virginia courts apply fiduciary duty principles with a sliding scale perched on the ill-defined boundaries of contract and tort law, legal and equitable remedial powers, and mixed questions of fact and law. The resulting field of uncertainty creates fertile soil for creative lawyering. The seedlings of presentation and characterization can grow into sturdy trunks of liability or defense.

In the context of some business disputes, there is the opportunity or threat—depending on which side of the courtroom you are on—to supplant the logical law of contract with the vagaries of the law of fiduciary duty.

A Trilogy of Fiduciary Duty Decisions

The Supreme Court of Virginia has described the essence of fiduciary duty as where one person sustains a fiduciary relationship to another, he or she cannot acquire an interest in the subject matter of the relationship adverse to such other party. *Greenspan v. Osheroff*, 232 Va. 388, 400, 351 S.E.2d 28, 36 (1986). In the context of employment, an employee's fiduciary duty to his employer prohibits the employee from acting against his employer's interests. *Hilb, Rogal & Hamilton Co. v. Depew*, 247 Va. 240, 246, 440 S.E.2d 918, 921 (1994).

Flippo v. CSC Associates

In *Flippo v. CSC Associates*, 262 Va. 48, 547 S.E.2d 216 (2001), the Supreme Court affirmed the trial court's decision holding two members of a limited liability company (LLC) liable for breach of fiduciary duty to the LLC and awarding compensatory damages, punitive damages and attorneys' fees. The defendant LLC members (Carter and Arthur Flippo) implemented a transaction transferring the noncash assets of the closely held LLC to a joint venture, resulting in the dissolution of the original LLC. The defendant Carter Flippo acted as the LLC's manager. The transaction was intended to benefit the Flippos' personal estate planning goals.

The Flippos implemented the asset transfer transaction without notice to or approval by the third LLC member, CSC Associates; the Flippos concealed their preparatory actions and presented the new joint venture to CSC Associates as a completed transaction. Predictably, CSC Associates brought individual and derivative claims against the Flippos.

The Flippos asserted three defenses: reliance on advice of counsel, the good faith business judgment rule and the terms of the LLC's operating agreement that authorized the actions taken. The Court

The Court stated that an act that is otherwise legal might nevertheless breach one's fiduciary duty.

rejected these defenses. The trial court found that the Flippos sought legal advice to advance their personal estate planning goals; the legal advice, therefore, was not related to the LLC's business interests. This finding dispatched the advice of counsel and business judgment rule defenses.

The Court analyzed the Flippos' argument that the legal advice upon which they acted involved steps that could "legally" be taken by the manager under the terms of the operating agreement. The Court stated that such "legality" was irrelevant in determining the availability of the business judgment rule as a defense. The Court stated that an act that is otherwise legal might nevertheless breach one's fiduciary duty. Following advice given solely for the purpose of implementing the Flippos' personal estate planning goals, even if the steps taken were "legal," was an action neither sought nor taken with the intent of benefiting the LLC. Following such legal advice, therefore, could not be the basis for asserting the good faith business judgment rule as a defense. 262 Va. at 57, 547 S.E.2d at 222.

Feddeman & Co. v. Langan Associates

In *Feddeman & Co. v. Langan Associates*, 260 Va. 35, 530 S.E.2d 668 (2000), the trial court had set aside a $3,300,000 jury verdict in favor of an accounting firm. The Supreme Court reversed and reinstated the verdict.

Feddeman owned 95 percent of the accounting firm and had initiated negotiations about the possible sale of the firm to Langan Associates. During this negotiation process, a "buying group," made up of several senior Feddeman employees, emerged. The buying group planned to purchase Feddeman's interest in the firm and then merge the two accounting firms. The buying group hired Langan Associates's attorney to represent them.

During the course of contentious negotiations with Feddeman, the buying group asked for and received legal advice about what they could and could not do if they chose to resign as Feddeman & Co. employees. The buying group decided that the possibility of their resignations would be leverage used in the negotiation.

When the negotiations failed, the buying group members organized a mass resignation of Feddeman & Co. employees. Immediately after the mass resignation, the former Feddeman & Co. employees solicited the firm's clients and remaining employees to transfer their business and employment to Langan Associates.

The jury returned a verdict for Feddeman & Co. on claims of breach of fiduciary duty, usurpation of corporate opportunity, intentional interference with contractual relationships and statutory business conspiracy. In setting aside the verdict, the trial court accepted the defense arguments that the departing employees, prior to their resignations, had engaged only in reasonable preparations to compete with Feddeman & Co.

The Supreme Court agreed that, prior to resignation, the defendants were entitled to make arrangements to resign, including plans to compete with their employer and that such conduct would not ordinarily result in liability for breach of fiduciary duty. The Court continued, however, that the right to make such arrangements was not absolute. The right, based on a policy of free competition, must be balanced with the importance of the integrity and fairness attaching to the relationship between employer and employee or corporation and corporate director. The Court noted that under certain circumstances the exercise of the right might constitute a breach of fiduciary duty.

The Court then analyzed case law dealing with the scope of an employee's right to prepare to compete with his or her former employer. In applying this case law, the Virginia court noted that the defendants met and formulated a plan to resign *en masse* knowing that a resignation by all of them would devastate Feddeman & Co. The plan anticipated future employment with Langan & Associates and securing Feddeman & Co.'s clients and employees as clients and employees of Langan Associates. The defendants informed other employees of the plan to resign, supplied resignation letters for use by the other employees and told the other employees that they could join them with the new employer. The Court concluded that this evidence showed that the defendants did more than prepare to leave their employment and advise others of their plans. Rather, the "totality of the defendants' actions" provided credible evidence to support the jury determination that their conduct fell below the required standard of good faith and loyalty and constituted a breach of fiduciary duty. The Court, therefore, held that the trial court erred in setting aside the jury verdict in favor of Feddeman & Co.

The Supreme Court also analyzed the relationship between the defendants' liability for breach of fiduciary duty and their liability under a statutory business conspiracy theory. The Court focused on the concerted actions of Langan & Associates and the individual defendants, the employee defendants' plan to use the resignation threat as leverage in the negotiations and their knowledge that their plan would severely injure Feddeman & Co. The Court noted that Langan & Associates was aware of the plan and facilitated its development by providing legal services and agreeing to hire Feddeman & Co.'s former employees. The Court concluded that the evidence was sufficient to support a jury finding that the planned resignation *en masse* from Feddeman & Co. was a breach of the employee defendants' fiduciary duties and that Langan & Associates assisted the individual defendants in breaching their fiduciary duties. The defendants' actions, therefore, were with-

out legal justification. The Court directly linked the employees' liability for breach of fiduciary duty and their enhanced liability, and that of their new employer, under *Virginia Code Ann*. §§ 18.2-499 and 18.2-500.

Williams v. Dominion Technology Partners

In *Williams v. Dominion Technology Partners*, 265 Va. 280, 576 S.E.2d 752 (2003), the Supreme Court reversed a judgment based on a jury verdict for the employer, Dominion Technology Partners, for compensatory and punitive damages under theories of breach of fiduciary duty, intentional interference with contractual relationships and statutory business conspiracy. The defendant, Williams, was an at-will employee of Dominion assigned to work on a temporary basis on a computer project for a company known as Stihl Inc. Williams's work for Stihl was implemented through an employment brokerage company known as ACSYS. Williams and Dominion had not entered into any contract for confidentiality or restricting Williams's right to go to work for ACSYS, Stihl or any other party. While still a Dominion employee, Williams arranged to become an ACSYS employee at higher pay while continuing to work on Stihl's projects. Williams then gave the required notice to Dominion and resigned.

The Court, as it had done in *Feddeman & Co. v. Langan Associates*, analyzed the allowed activity of an employee in making arrangements while still employed to compete with his or her employer after resigning. The Court stated that the essential facts asserted to support the three theories of liability (breach of fiduciary duty, intentional interference with contract relationships and statutory business conspiracy) were intricately interrelated. The Court framed the dispositive question, addressing all three theories of liability, as whether Williams's conduct was sufficient to constitute a breach of his fiduciary duty of loyalty to Dominion.

The Court stated expressly that whether such a fiduciary duty exists is a question of law to be determined by the trial court. Only if the evidence were sufficient to establish this duty as a matter of law would it become a matter for the jury to determine whether the employee had breached the fiduciary duty.

This division of fiduciary duty issues into questions of law and fact will be difficult to apply in future cases. Williams, as an employee of Dominion, clearly had a fiduciary duty to Dominion. The scope of his fiduciary duty may have been reduced by the temporary and project-based nature of his employment. It appears that the Court adopted an analytical approach that determining whether a specific action, such as arranging to go to work for ASCYS, violated a fiduciary duty is a question of law, rather than a question of fact.

The Court concluded that the trial court erred in ruling as a matter of law that the employer's evidence was sufficient to establish that Williams had a fiduciary duty to Dominion in the facts presented. 265 Va. 280, 291, 576 S.E.2d at 758. Although not expressly stated, presumably the Court's legal conclusion on the existence of a fiduciary duty in the facts presented was based on the temporary at-will nature of Williams's employment and Dominion's failure to take advantage of available contractual tools to protect its interests. Many attorneys also read *Williams* as establishing a sliding-scale analysis in determining whether a fiduciary duty exists and what conduct will violate an employee's duty. Under such a sliding scale analysis, a temporary technical employee such as Williams is allowed a freedom of action that would create liability if undertaken by a company leader. One sage observer notes that *Williams* simply acknowledges the mobility of skilled labor and the legal right of talented people to seek the best available situation.

The Court reversed the judgment against Williams on all counts because the same conduct asserted as the basis for the fiduciary duty breach was also the basis for liability asserted under the intentional interference with contractual relationships and statutory business conspiracy claims.

Remedy Issues

In addition to opening the door to liability on multiple theories, a breach of fiduciary duty may serve as the foundation for multiple remedies. In *Feddeman & Co. v. Langan Associates, Advanced Marine Enterprises v. PRC, Inc.*, 256 Va. 106, 501 S.E.2d 148 (1998), and *Greenspan v. Osheroff*, breach of fiduciary duty claims served as the basis for substantial compensatory damages awards. These awards were subject to enhancement as treble damages under the accompanying statutory business conspiracy claims.

In *Flippo v. CSC Associates*, the Supreme Court affirmed the award of punitive damages based on the defendant's breach of fiduciary duty. Compare *O'Connell v. Bean*, 263 Va. 176, 556 S.E.2d 741 (2002) (Decision holding that punitive damages may not be awarded in an action against an attorney for breach of fiduciary duty.)

In addition to opening the door to liability on multiple theories, a breach of fiduciary duty may serve as the foundation for multiple remedies.

When combined with shareholder or member derivative claims, a breach of fiduciary duty can result in the award of attorneys' fees as resulted in *Flippo v. CSC Associates.* Attorneys' fees and costs will also be awarded in cases where liability is

found under a statutory business conspiracy claim as was done in *Advanced Marine Enterprises v. PRC Inc.*

To the extent that a plaintiff has done something that may have set the events in motion, the defendant's sneaking around will overshadow any fault of the plaintiff.

Equitable remedies are also available to remedy a breach of fiduciary duty. *See Greenspan v. Osheroff* (imposition of constructive trust). In *Flippo v. CSC Associates*, the Court noted that claims to recover transferred assets were moot because the defendant entity returned the assets prior to trial; presumably, the Court would have addressed the availability of this rescission-type remedy if the transferred assets had not been returned.

Deja Vu All Over Again

A systematic reading of Virginia decisions involving business disputes uncovers three recurring fact patterns. The exercise also illustrates a huge appetite for risk among those individuals who end up as defendants in these cases. The recurring fact patterns are useful in evaluating business dispute cases, structuring pleadings, organizing matters of proof and giving advice before a crisis matures.

A Change in Direction

The first recurring fact pattern is a pending change in the fundamental structure of the business. The cases include situations in which the majority owner decides to put the business up for sale (*Feddeman & Co. v. Langan Associates*), one of the principals of the business becomes ill and incapacitated for a period of time (*Greenspan v. Osheroff*), and a larger business announces its intent to sell or eliminate a division (*Advance Marine Enterprises v. PRC Inc.)*.

The pending change in the business puts the players at risk: self-preservation and self-interest may then prevail over risk management and prudence. Reading the reported cases, it appears that the parties' actions support the ultimate outcome of the litigation. Such clarity of vision, however, is impossible when the events are taking place and the shifting facts have not hardened into a cold factual record.

The Opportunist

A second recurring fact pattern involves an opportunist who seizes advantage of the evolving situation or creates the situation, giving himself or herself advantages and "leverage" to use against an employer or other LLC member or shareholder. *Flippo v. CSC Associates*, *Feddeman & Co. v. Langan Associates*, *Advance Marine Enterprises v. PRC Inc.*, *Greenspan v. Osheroff* and *Williams v. Dominion Technology Partners* all involved opportunistic actions. These cases also tend to illustrate subpatterns of young turks versus the old guard, mass resignations and the use of "leverage."

An additional subpattern is the defense argument that the legitimate purposes that the opportunists have articulated (such as taking care of patients or customers or promoting legitimate competition) overrides any improper purpose. The Supreme Court of Virginia summarily rejected such a "mixed motive" defense in its analysis of the malice element of a statutory business conspiracy claim. *See Greenspan v. Osheroff*, 232 Va. at 397, 398, 351 S.E. 2d at 35. In such circumstances, the Court held that the defendant's improper motive satisfied the required element of proof notwithstanding any legitimate motives accompanying the improper motive.

The Legality Defense

The third recurring fact pattern is the assertion of the legality of the challenged actions, whether as authorized by the entity documents (*Flippo v. CSC Associates*) or by common law (the principle that an employee is allowed to prepare to compete with his or her employer prior to resignation). Disputes falling into this category often involve advice of counsel issues as the defendants try to hide behind the short skirts of their lawyers.

In the context of fiduciary duty issues, the Supreme Court has had no problem rejecting the legality defense as was done in *Flippo v. CSC Associates* and *Feddeman & Co. v. Langan Associates*. On the other hand, in the right fact situation, the defense can succeed as it did in *Williams v. Dominion Technology Partners*.

The "Sneaking Around" Factor

One theme underlies the Supreme Court's approach to all of the recurring fact patterns: it is the sneaking around that gets the defendant into trouble. In *Flippo v. CSC Associates*, the defendants characterized their conduct as a legitimate "hard ball" response to CSC Associates's refusal to comply with the Flippos' wishes. The Supreme Court rejected this defense and quoted the trial court's description of the defendants' actions as "secretive, concealed, dishonest" and "an attempt to steal property worth millions of dollars." 262 Va. at 59, 547 S.E. 2d at 223.

In *Feddeman & Co. v. Langan Associates*, the Court noted that the defendants had conducted nighttime meetings at various defendants' homes and described busy evening activities collecting resignation letters to implement the planned mass resignation. 260 Va. at 39, 40, 530 S.E. 2d at 670-671. In *Advance Marine Enterprises v. PRC Inc.*, the Court detailed the defendant's actions intended to keep the employer from gaining knowledge of the mass transfer plan and to keep information about the plan from employees who would "blab."

The law, of course, does not provide relief to every "disgruntled player in the rough-and-tumble world comprising the competitive market place." *Feddeman & Co. v. Langan Associates (*quoting *ITT Hartford Group, Inc. v. Virginia Financial Associates, Inc.*, 258 Va. 193, 204, 520 S.E.

2d 355, 361 (1999). Nevertheless, in fiduciary duty cases, it is the "sneaking around" that will get defendants into trouble. To the extent that a plaintiff has done something that may have set the events in motion, the defendant's sneaking around will overshadow any fault of the plaintiff. Fiduciary duty principles are intended to protect the economic value of business relationships and to maintain the rule of law and predictability in business, rather than the law of the jungle. A defendant's covert actions will be taken by a court or jury as an unmistakable signal that predators were afoot.

On the Giving of Advice

Given the evolving case law, the recurring fact patterns and the "sneaking around" principle, what approach should a lawyer take in advising clients when presented with a similar fact situation? Clients will generally have only the vaguest idea of what they can or cannot do in these situations. Guided by their personal interests, most of the true opportunists of the world will act first and seek advice later. If they do seek counsel, it will be based on "facts" that often only loosely resemble the real world.

The good client will present on your doorstep frustrated by an unacceptable business relationship and looking for a fair way out that does not unduly sacrifice his or her economic self-interest. Clients will be emotional and motivated because of the financial stakes and their personal involvement.

There will be as many approaches to these dilemmas as there are lawyers. Several factors, however, will generally come into play. First, the parties should manage risk—not create or maximize risk. This principle will keep the client—and the lawyer—out of trouble. As the size of the verdicts and the availability of punitive and treble damages indicate, the litigation consequences for stepping over the line can be severe. Aggressive actions or creative lawyering that maximizes negotiating leverage or pulls a rabbit out of a business-dispute hat may end up being an expensive approach to the problem. The value of an enterprise is in its employees, their knowledge and their relationships with customers and clients. Actions intended to transfer these values as a unit to a new home, particularly when accomplished by sneaking around, are likely to run afoul of fiduciary limits.

Second, the lawyer has to watch out for shifting sand—the lawyer's role may change in the midst of events. In *Flippo v. CSC Associates*, the Court reviewed the advising lawyer's dual role as counsel to the LLC entity and counsel to the Flippos as individuals. In *Feddeman & Co. v. Langan Associates*, the role of the advising lawyer went from an apparently cooperative role to a fully adverse role in advising the employees on how far they could go in preparing to compete with Feddeman & Co. prior to resignation, and facilitating a plan to maximize negotiating leverage through preparation for a mass resignation of employees. As was the case in *Flippo v. CSC Associates*, the lawyers in *Feddeman & Co. v. Langan Associates* also labored under the disability of having more than one client in the fray. The courts will punish the client, and the lawyer may also suffer, if the lines of representation and responsibility become entangled.

A lawyer's practice area may also affect his or her approach to these issues. A transactional lawyer may become entranced by the logical coherence and the strict legality of a proposed transaction. This reliance on mere legality in an overreaching transaction should be leavened by a healthy dose of skepticism based on fiduciary principles.

Third, client discipline is always a pitfall; some clients will want to play "hard ball." Other clients will be wrestling with intense feelings of personal betrayal. The client's insatiable appetite for risk while the game is afoot may become the lawyer's fault once the motion for judgment is served. In this difficult situation, a lawyer cannot expect the client to disclose all of the facts—the good, the bad and the ugly—or stay within the limits of acceptable conduct the lawyer has prescribed. In a pressure-packed situation with livelihoods at stake, the client will be tempted to push the limits no matter what cautionary advice he or she has received.

A Last Word

The recurring fact patterns illustrate the kinds of facts the courts have found important in analyzing fiduciary duty claims. The plaintiff's attorney will seek out facts that show the defendants "sneaking around" and serving their own interests at the expense of the interests of those to whom they owe fiduciary obligations. The defense counsel will investigate facts that show the plaintiff launched the events, other facts that mitigate and minimize the scope of the fiduciary obligations, and facts, that establish that the defendant's self-interest and legitimate purposes were not unduly adverse to the plaintiff's interest.

A lawyer scarred by battles in these arenas suggested to me that the best lawyering often involves finding a business solution to these disputes at the earliest possible moment. Getting people back to their lives and work and out of courtrooms can have substantial value to our clients. ⚖

Gregory J. Haley is a partner with Gentry Locke Rakes & Moore LLP in Roanoke. He is a member of the Virginia State Bar Litigation Section's Board of Governors. His practice focuses primarily on business and government litigation.