

# The Duty of Loyalty and Preparations to Compete

by Kevin Allen and Jennifer Schlatter

This column is sponsored by the CBA Labor Law Forum Committee to present current issues and topics of interest to attorneys, judges, and legal and judicial administrators on all aspects of labor and employment law in Colorado.

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**This article summarizes the current status of Colorado law regarding the duty of loyalty and permissible preparations to compete by employees, and the practical implications of advising employees and employers pertaining to such preparations.**

Employers frequently face the possibility of employees resigning and going to work for a competitor. Occasionally, employees leave their current employer to start a competing business, and additional employees might accompany them in leaving the current employer to join the new business venture. To properly advise employees who are planning such a departure, attorneys must be mindful of the balance between the right of employees to pursue their livelihoods and the right of employers to avoid injury as a result of the opportunistic behavior of departing employees.

For example, consider the scenario of employees who leave an employer to start a competing business. The employees may rely on their skills and knowledge of the industry to start the rival enterprise. They may investigate potential markets, locations, and financing. While still employed, they also may obtain financing, purchase or lease a building for the new business, prepare and file articles of incorporation, acquire business cards and stationery, and install a fax and phone line. To elevate the stakes even more, the employees may make and receive calls on their cellphones relating to the new venture during business hours. They may discuss with current clients or co-employees the possibility of joining the new business. All of the above actions by the employees are done to prepare for the day they leave their

current employment, and in an effort to immediately commence operations of the new business.

Colorado law provides that employees owe the employer a duty of loyalty and must not, while employed, act in a manner that is contrary to the employer's interests.<sup>1</sup> However, employees need not wait until the morning after the employment terminates to begin preparing to compete with the former employer.<sup>2</sup> The issue that often arises in such cases is determining at what point the preparations to compete become a breach of the duty of loyalty owed to the employer.

Despite the importance of the duty of loyalty and high stakes in drawing the line between permissible preparatory conduct and actionable disloyalty, this area of law has garnered relatively little detailed analysis in Colorado. As a result, courts, attorneys, and clients must deal with uncertainty when confronted with the nebulous area of "preparations to compete."

This article examines the current status of Colorado law regarding permissible preparations to compete, and the practical implications of advising employees pertaining to such preparations. After discussing the relevant case law, this article presents guidelines for advising clients who are planning to solicit customers, prepare new businesses, and resign from their current employment in a group.

## The Genesis of the Duty of Loyalty

When approached by a client facing the above issues, there are few Colorado cases to which an attorney can turn. Practitioners representing such clients should be familiar with *Jet Courier Service, Inc. v. Mulei*,<sup>3</sup> ("Jet Courier") and its progeny.

### The Jet Courier Case

In the *Jet Courier* case, the plaintiff was an air courier company based in Ohio that supplied a specialized transportation service to customer banks. Jet Courier provided air and incidental ground courier service to carry canceled checks for the banking system. In 1981, Jet Courier established Denver operations. In February of that year, Mulei was hired to manage the Denver operations.

Before commencing employment with Jet Courier, Mulei worked for another air courier service in a management capacity and had worked in the business for several years. He also had numerous business connections in the banking industry in Denver and other cities. As a condition of his employment, Jet Courier required that Mulei execute an employment agreement containing a non-competition covenant, whereby Mulei agreed not to compete with Jet Courier for two years after termination, with no geographic restriction.

During his employment, Mulei became progressively dissatisfied with Jet Courier and, as a result, began to look for other work in the air courier field. In the course of seeking other employment opportunities and while still employed by Jet Courier, Mulei investigated setting up another air courier company that would compete with Jet Courier.

Mulei's pre-termination actions consisted of: (1) speaking and meeting with a Kansas air charter operator who was in the business of supplying air transportation services to discuss starting a partnership; (2) meeting with two Jet Courier employees to discuss starting a new business and acquiring customers; (3) communicating with Jet Courier's customer banks to inform them he would be leaving Jet Courier and that he would provide the same services to them; (4) communicating with Jet Courier's customers regarding his ability to reduce costs; (5) meeting with nine of Jet Courier's pilots to discuss the formation of the new venture; (6) meeting with Jet Courier's Denver office staff to discuss poten-

tial future employment with his new venture; and (7) incorporating the new business.

When Jet Courier learned that Mulei was organizing a competing business, his employment was terminated. That same day, Mulei caused his new venture to become operational and begin competing with Jet Courier. Several customers of Jet Courier followed Mulei to his new business, as did three of the four other employees of Jet Courier's Denver office. All of Jet Courier's ground carriers in Denver also joined Mulei's business.

Mulei filed suit against Jet Courier, seeking to recover unpaid compensation as well as a declaratory judgment that the non-competition covenant was void. Jet Courier counterclaimed for breach of contract, breach of fiduciary duty, and civil conspiracy. The district court concluded that Mulei's non-competition covenant was void for lack of consideration and unreasonableness and that Mulei did not violate his duty of loyalty. As a result, Jet Courier's counterclaims were dismissed. The Court of Appeals affirmed.<sup>4</sup>

The Colorado Supreme Court granted *certiorari* to review the decision of the Court of Appeals on three issues: (1) whether the district court erred in concluding that Mulei did not violate a duty of loyalty to Jet Courier; (2) whether any breach by Mulei of a duty of loyalty owed to Jet Courier prevented Mulei from obtaining full recovery of the salary, bonus, and statutory penalty otherwise due him; and (3) whether the district court erred in dismissing Jet Courier's civil conspiracy claims.<sup>5</sup> For the purposes of this article, the following discussion focuses only on the first issue.

**Breach of Duty of Loyalty:** The Colorado Supreme Court noted that whether an employee's actions in preparation for competing with his employer constituted a breach of the employee's duty of loyalty was an issue of first impression in Colorado. The Court turned to the *Restatement (Second) of Agency*<sup>6</sup> for guidance on applying the duty of loyalty to a preparation to compete action. The Court determined that it is the "nature of the employee's preparations which is significant" in determining whether a breach of duty of loyalty has occurred.<sup>7</sup> The Court noted that other jurisdictions have recognized "a privilege in favor of employees which enables them to prepare or make arrangements to compete with their employers prior to leaving the employ of their prospective rivals without fear of incur-

ring liability for breach of their fiduciary duty of loyalty."<sup>8</sup>

With respect to soliciting co-employees for a competing venture, the Court set forth a three-part test for determining when such solicitation was impermissible. Factors to be considered are: (1) the nature of the employment relationship; (2) the impact of the employee's actions on the employer's operations; and (3) the extent of any benefits promised or inducements made to co-workers to obtain their services for the new competing enterprise.<sup>9</sup> Factors such as the solicited employee's position and responsibilities and whether the solicited employee is an at-will employee also are relevant.<sup>10</sup>

In a thoroughly pragmatic analysis of the issue, the Court stressed that this three-part test should be flexible so that actions traditionally taken by departing employees with regard to co-workers leaving simultaneously will not amount to a breach of duty of loyalty unless other factors, such as the extent of the solicitations or nature of the offers of employment dictate finding of a breach of the duty of loyalty.<sup>11</sup>

The Court further indicated that not all solicitations of co-employees are improper:

Under this flexible approach, traditional actions by departing employees, such as the executive who leaves with her secretary, the mechanic who leaves with his apprentice, or the firm partner who leaves with associates from her department, would not give rise to a breach of loyalty unless other factors, such as an intent to injure the employer in the continuation of his business, were present.<sup>12</sup>

As to solicitations of customers, the *Jet Courier* Court concluded, "an employee may advise customers that he will be leaving his current employment."<sup>13</sup> However, the Court emphasized that the employee may not solicit customers for future business.<sup>14</sup>

Armed with these legal principles, the Court concluded that the trial and appellate courts had applied unduly narrow standards in determining what actions constituted a breach of the duty of loyalty. The Court remanded the case for a retrial and instructed the lower court to consider, under the standards adopted, whether Mulei had violated his duty of loyalty. The Court also held that Mulei would not be entitled to any compensation or bonus payments for the period during which he was disloyal. The *Jet Courier* de-

cision stands squarely for the proposition that, regardless of the competitive pressures facing departing employees, they cannot seek to position themselves for instant success at the expense of their employers.

### Subsequent Case Law

Although the facts of *Jet Courier* unequivocally demonstrated wrongful conduct by the employee, cases that come through an attorney's door are rarely so clear-cut. Although the standards in *Mulei* are often cited, cases following *Mulei* offer little guidance for dealing with facts similar to those set forth in the hypothetical presented in the introduction of this article. Determining whether conduct in a given case amounts to a breach of the duty of loyalty in a preparation to compete case requires a close analysis of the facts and circumstances, with particular attention given to the nature of the preparations.

For example, in *Koontz v. Rosener*<sup>15</sup> four plaintiff real estate salespersons bought into a real estate brokerage firm while still employed by a competing firm. Before being terminated from the original firm, the plaintiffs systematically listed properties for only a short time and failed to list other properties in an attempt to keep the potential listings available for their competing venture.<sup>16</sup>

The Colorado Court of Appeals, quoting with emphasis the precedent set forth in *Jet Courier*, found that the plaintiffs' actions were tantamount to active competition and were not in the employer's best interests "but [were] done with a view toward promoting [the employee's] private interests at [the employer's] expense and to its detriment."<sup>17</sup> The court found the agreement among the plaintiffs to terminate their employment *en masse* "evidenced an intent to diminish [the employer's] prospective ability to compete with their anticipated venture and thus violated a duty of loyalty owed to [the employer]."<sup>18</sup>

In *Graphic Directions, Inc. v. Bush*,<sup>19</sup> defendants Bush and Dickerson were employed by Graphic Directions, a graphics business. Bush ultimately became the Vice-President and Marketing Director, and Dickerson became the Art Director. Dissatisfied with the management of Graphic Directions, Bush made preparations to start a competing business and discussed his plans with Dickerson and another Graphic Directions employee. Shortly thereafter, the three employees re-

signed from Graphic Directions and immediately began a competing graphics business. Graphic Directions filed suit asserting a claim for breach of fiduciary duty. At trial, the jury returned a verdict against Bush and Dickerson. Bush and Dickerson appealed.

Dickerson argued that because he was an hourly employee with no management or administrative authority, he was not subject to the fiduciary duties outlined in *Jet Courier*. The Colorado Court of Appeals disagreed, stating that the duty of loyalty was based, in part, on agency law.<sup>20</sup> The Court of Appeals observed that the *Jet Courier* decision suggested that a higher standard of the duty of loyalty may be appropriate only where an employee has sufficient authority to act for the employer or has access to confidential information.<sup>21</sup> However, based on his appointment to the position of Art Director, Dickerson was cloaked with such authority and the court applied the principal/agent analogy.

The Court of Appeals held that even though the evidence was not "overwhelming," it was sufficient to support the jury's conclusion that Bush and Dickerson breached their fiduciary duty to Graphic Directions.<sup>22</sup> Although it acknowledged that employees may make preparations to compete after termination of their employment, including advising current customers that they will be leaving, the court also recognized that obligations of loyalty are necessary to protect the employer.<sup>23</sup>

In *T.A. Pelsue Co. v. Grand Enterprises, Inc.*,<sup>24</sup> the court found that Beaver, a former director of T.A. Pelsue Co. ("Pelsue"), breached his duty of loyalty when he, while still employed by Pelsue, actively engaged in designing, manufacturing, and selling products for a competing business, as well as the solicitation of Pelsue's customers.<sup>25</sup> After resigning as a director and full-time employee, Beaver continued to receive group insurance coverage and other benefits from Pelsue.

The court noted that Beaver used information and resources that were available to him during his many years of employment with Pelsue to develop and promote the competing business to the detriment of Pelsue. The court relied on *Mulei* in finding a breach of the duty of loyalty, but also applied a heightened view of the duty, given Beaver's relationship to the employer:

Resignation or termination does not automatically free a director or employee from his or her fiduciary obligations. A

former director breaches his or her fiduciary duty if he or she engages in transactions that had their inception before the termination of the fiduciary relationship or that were based on information obtained during that relationship. Once the fiduciary relationship is terminated, employees may compete with their employers as long as prior fiduciary confidences are not used to the corporation's detriment.<sup>26</sup>

Thus, the court seems willing to scrutinize the pre- and post-termination behavior of directors more closely than that of employees with less responsibility.

### Practical Considerations In Advising Clients

Although the *Jet Courier* decision and its progeny indicate that it is permissible for employees to engage in preparations to compete with employers, Colorado courts will not permit conduct that offends basic and practical notions of fairness. Accordingly, issues involving the nature and extent of the preparations to compete pose significant problems for attorneys advising clients. Such problems may arise, for example, when the employees solicit customers, prepare new business ventures, and plan mass resignations.

### Solicitation of Customers

Solicitation of customers for a new business while still employed is not permitted by Colorado law.<sup>27</sup> However, drawing the line between permissible and impermissible conduct can be difficult. An employee may wish to verbally notify a customer of his or her plans to leave the current employer to start a new venture, or to send written notification of the new business using newly acquired stationery and business cards. Practitioners should be prepared to advise clients whether such conduct constitutes improper solicitation.

Although *Jet Courier* indicates that an employee may advise customers that he or she is leaving the current employment to compete with the employer,<sup>28</sup> Colorado law does not specifically address the issue of written announcements. A primary purpose of sending an announcement is to inform customers that the new venture will be available to assist them, and the announcement could lead to conversations between the employee and customer. Case law from other jurisdictions suggests that sending an announcement should not be construed as improper solicitation.<sup>29</sup>

Distinguishing between "discussions" and "solicitations" can be difficult. Employees should be warned that any overture, no matter how innocuous, to a customer relating to obtaining the customer's future business could rise to the level of impermissible solicitation. If the employee and customer have a long-standing relationship, it is likely that the employee would wish to continue working for that customer. However, to avoid breaching the duty of loyalty, the employee should consider waiting until after he or she has left the current employment before engaging in discussions with the customer.<sup>30</sup>

### **Preparation of New Businesses**

Employees might seek legal advice when determining what actions to take when preparing to compete with current employers. Based on the case law discussed above, employees should be urged to take no action to prepare new business ventures while on company time and to refrain from using company resources.<sup>31</sup> Employees likely would look for office space, meet with bankers to secure loans for the new business, or discuss business needs with an office supply company be-

fore establishing the new business. Employees should be urged to limit such activities to lunch breaks, after hours, or over the weekend—never during work hours. They should avoid using company resources such as fax machines, computers and computer networks, and phones to prepare their competitive business activities.

Other activities done in preparation to compete with a current employer are not specifically limited by Colorado law. However, as suggested in *Jet Courier*, and alluded to in *T.A. Pelsue Co.*, the higher the level of the employee and the commensurate access the employee had to confidential information of the employer, the more likely a court is to subject the preparatory activities to greater scrutiny, even if not accomplished on company time. For example, an employee might visit a company vendor over the weekend to secure that vendor as a supplier for his or her new business; however, if the employee's knowledge of the vendor's pricing practices resulted from his or her position as an employee or access to confidential information, such otherwise innocuous behavior may come under greater scrutiny.

### **Mass Resignations**

As alluded to in *Koontz*, an agreement among employees to terminate their employment *en masse* can evidence an intent to diminish the employer's prospective ability to compete and thus violate the duty of loyalty. On the other hand, *Jet Courier* suggests that the firm partner who leaves with associates from a department of a law firm would not breach the duty of loyalty unless other factors, such as an intent to injure the employer, were present.

When advising a group of employees planning to leave an employer, an attorney should be mindful of these of considerations. Factors to consider in determining whether a group of employees can leave an employer at the same time after having had discussions among themselves, without breaching the duty of loyalty, include: (1) their overall significance in relation to the size of the employer; (2) their level of importance to the employer; (3) their access to confidential or proprietary business information of the employer; (4) their ability to use such information to the employer's detriment; (5) the willingness of the employees to give notice of their intent to depart; and (6) their moti-

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vations for leaving, including their own perceptions of how they are being treated by the employer.<sup>32</sup>

Employees who perceive that they are underpaid or who may be subject to a reduction in force and wish to seek better employment elsewhere may be viewed sympathetically, even if harm to the employer results. Similarly, a group of employees who are a small part of a much larger operation may not harm the employer's interest when they depart, even though they may be valued employees. Another factor a lawyer should consider when advising clients is whether the employer has provided the employees with significant confidential information that can be easily used against the employer's interests, as well as the desire of the employees to use that information.

## Conclusion

Counsel advising employees who may be planning to leave an employer to establish a competing business must consider numerous issues when providing such advice. It is not enough to conclude that *Jet Courier* prohibits only solicitation of employees and customers, because employees may be contemplating additional types of business preparations in addition to such solicitation. Courts have adopted a flexible approach, which includes analyzing the employees' role in the employer organization. Therefore, it is imperative that counsel obtain sufficient information regarding the client's circumstances and role with the employer to properly advise as to what preparatory steps may be permissible. Practitioners also should advise clients to be cautious when preparing to compete with employers, because the case law provides little insight into how the courts will resolve disputes if litigation results from the activities of departing employees.

## NOTES

1. See, e.g., *T.A. Pelsue Co. v. Grand Enters., Inc.*, 782 F.Supp. 1476, 1486 (D.Colo. 1991) (employee has fiduciary duty not to engage in enterprises directly in competition with and necessarily having injurious or detrimental effect on employer's business); *Alexander & Alexan-*

*der, Inc. v. Frank B. Hall and Co.*, 1990 WL 8028, \*8 (D.Colo. 1990) (employee must act solely for employer's benefit in all matters connected with employment, giving due regard to employee's right to make preparations to compete).

2. *Jet Courier Service, Inc. v. Mulei*, 771 P.2d 486, 493 (Colo. 1989):

In attempting to accommodate the competing policy considerations of honesty and fair dealing on the one hand and free and vigorous economic competition on the other, courts have recognized a privilege in favor of employees which enables them to prepare or make arrangements to compete with their employers prior to leaving the employ of their prospective rivals without fear of incurring liability for breach of their fiduciary duty of loyalty (*internal citations omitted*).

3. *Id.*

4. *Mulei v. Jet Courier Service, Inc.*, 739 P.2d 889 (Colo.App. 1987).

5. *Jet Courier*, *supra*, note 2 at 491.

6. *Restatement (Second) of Agency* § 387.

7. *Jet Courier*, *supra*, note 2 at 492-93.

8. *Id.* at 493, citing *Maryland Mutual, Inc. v. Metzner*, 382 A.2d 564, 569 (1978).

9. *Id.* at 497.

10. *Id.*

11. *Id.* at n. 13.

12. *Id.* at 495.

13. *Id.* at 494.

14. *Id.*

15. *Koontz v. Rosener*, 787 P.2d 192 (Colo. App. 1989).

16. *Id.* at 195.

17. *Id.* at 196.

18. *Id.*

19. *Graphic Directions, Inc. v. Bush*, 862 P.2d 1020 (Colo.App. 1993).

20. *Restatement (Second) Agency*, *supra*, note 6.

21. *Mulei*, *supra*, note 4.

22. *Graphic Directions*, *supra*, note 19 at 1023.

23. *Id.*, citing *Mulei*, *supra*, note 4.

24. *T.A. Pelsue Co.*, *supra*, note 1.

25. *Id.* at 1485-86.

26. *Id.*

27. *Jet Courier*, *supra*, note 2.

28. *Id.* at 494; see also *Graphic Directions*, *supra*, note 19 at 1021.

29. For example, under California law, an employee is entitled to announce a new affiliation, even to those on a customer list that may constitute a trade secret. See *Aetna Bldg. Maint. Co. v. West*, 246 P.2d 11, 14 (Cal. 1952); *Morlife, Inc. v. Perry*, 66 Cal.Rptr.2d 731, 737-

38 (Cal. Ct.App. 1997); *Moss, Adams & Co. v. Shilling*, 224 Cal.Rptr. 456, 458-59 (Cal. Ct.App. 1986); see also *American Credit Indemnity Co. v. Sacks*, 262 Cal.Rptr. 92, 100 (Cal. Ct.App. 1989) ("the boundary separating fair and unfair competition in the context of a protected customer list has been drawn at the distinction between an announcement and a solicitation."). The seminal case, *Aetna Bldg. Maint. Co.*, *supra*, attempted to define this distinction as follows:

"Solicit" is defined as "To ask for with earnestness, to make petition to, to endeavor to obtain, to awake or excite to action, to appeal to, or to invite." "It implies personal petition and importunity addressed to a particular individual to do some particular thing. . . ." It means: "To appeal to (for something); to apply to for obtaining something; to ask earnestly; to ask for the purpose of receiving; to endeavor to obtain by asking or pleading; to entreat, implore, or importune; to make petition to; to plead for; to try to obtain." Merely informing customers of one's former employer of a change of employment, without more, is not solicitation. Neither does the willingness to discuss business upon invitation of another party constitute solicitation on the part of the invitee.

30. See, e.g., *American Express Fin. Advisors, Inc. v. Topel*, 38 F.Supp.2d 1233, 1247 (D.Colo. 1999), citing *Comm. Couns. Serv., Inc. v. Reilly*, 317 F.2d 239, 244 (4th Cir. 1963) ("during period of employment, employee cannot solicit for himself future business which his employer requires him to solicit for his employer; moreover, [i]f prospective customers undertake the opening of negotiations which the employee could not initiate, he must decline to participate in them.").

31. See, e.g., *E. D. Lacey Mills, Inc. v. Keith*, 359 S.E.2d 148, 155 (Ga. Ct.App. 1987) (finding full-time employees could not conduct "numerous" meetings, make "numerous" telephone calls, and be "frequently" absent in pursuit of plans to compete); *Long v. Vertical Techs., Inc.*, 439 S.E.2d 797, 801-02 (N.C. Ct.App. 1994) (employees violated fiduciary duties by using employer's employees, facilities, computers, and computer programs to set up competing business); *Alexander & Alexander Benefits Servs., Inc. v. Benefit Brokers & Consultants, Inc.*, 756 F.Supp. 1408, 1413-14 (D.Or. 1991) (discussing use of equipment during business hours).

32. See, e.g., *Jet Courier*, *supra*, note 2 at 496; *Koontz*, *supra*, note 15 at 195-196; *Graphic Directions*, *supra*, note 19 at 1021. ■

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