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Reading Restrictive Covenant Tea Leaves From State's High Court

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Anyone familiar with the law on employment restrictive covenants knows that it is not particularly easy to predict whether any given restriction will be enforced by the courts. So, when the New York Court of Appeals weighs in on issues concerning restrictive covenants, one is well advised carefully to consider and account for the latest pronouncements of the high court. Reading these important tea leaves may not always enable planning with precision, but ignoring them is ill-advised.

This is why the Court of Appeals' latest such decision, albeit rather brief, is an important read. In Brown & Brown v. Johnson, 25 N.Y.3d 364 (June 11, 2015) the Court of Appeals addressed two issues—(1) whether the courts in New York should enforce a choice of law provision in an employment contract that applied Florida substantive law, which differs markedly from New York law; and (2) whether to allow partial enforcement of a restrictive covenant by "blue penciling" the agreement, narrowing its scope to a permissible extent. While the court's discussion of the choice of law issue provides a helpful refresher on New York law, the more significant ruling resuscitated the judicial power to rewrite restrictive covenants to make them enforceable even when, as written, they are impermissibly overbroad.

In Brown, the Court of Appeals affirmed the Fourth Department's decision refusing to enforce the choice of law provision because Florida law strongly favors employers in considering whether restrictive covenants are enforceable and to what extent, thereby offending New York's strong public policy requiring a proper balance of the interests of the employee, the employer and the public in general. This affirmance was straightforward and did not represent any meaningful change in the governing law of New York.

More importantly and of potentially greater significance, however, is the Court of Appeals' reversal of the Fourth Department's unduly harsh and unbending refusal to blue pencil the restrictive covenant at issue.

Brown Facts and Background

To appreciate the significance of the Court of Appeals' decision in Brown, an understanding of the facts of the case and the analysis applied by the Fourth Department is necessary. The employer-plaintiff, a public company providing insurance and related services, terminated the defendant employee after four years of employment and then sued the employee and her new employer, seeking to enforce various restrictive covenants.

The employment agreement had been presented to the employee on her first day of work along with a number of other documents that she was required to sign and contained "the three covenants at issue…a non-solicitation covenant, which prohibited [employee] from soliciting or servicing any client of plaintiffs' New York offices for two years after termination of [employee's] employment; a confidentiality covenant, which prohibited [employee] from disclosing plaintiffs' confidential information or using it for her own purposes; and a non-inducement covenant, which prohibited [employee] from inducing plaintiffs' New York employees to leave plaintiffs' employment for two years after termination of [employee's] employment." The employment agreement also provided that it would be "governed by and construed and enforced according to Florida law."

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As relevant to the Court of Appeals' decision and here, the motion court granted defendant-employee's motion for summary judgment and dismissed the cause of action seeking to enforce the covenant not to solicit or service any of plaintiff-employer's clients for two years, by applying New York law instead of Florida law as provided in the contract. The Fourth Department disagreed with the motion court that "Florida law bears no reasonable relationship to the parties or the transaction" so as to enforce the Florida choice-of-law provision. Nevertheless, the Fourth Department affirmed summary judgment by refusing to apply Florida law because it was "truly obnoxious" to New York's public policy governing employment restrictive covenants.

In refusing to enforce the covenant against soliciting or providing services to the employer's customers post-employment, the Fourth Department relied heavily upon two New York decisions on point—BDO Seidman v. Hirshberg, 93 N.Y.2d 382, 690 N.Y.S.2d 854 (1999) and Scott, Stackrow & Co., C.P.A.'s v. Skavina, 9 A.D.3d 805, 780 N.Y.S.2d 675 (3d Dept. 2004), lv. denied, 3 N.Y.3d 612 (2004). In BDO Seidman, the Court of Appeals held that the applicable restrictive covenant could only be enforced to the extent of restricting the accountant employee from serving clients to whom his employer introduced him during the employment relationship, rather than those clients with whom he had a previous relationship or those he never served while employed by plaintiff employer.

The Fourth Department applied the same analysis to the non-solicitation provision before it in Brown, finding that the employee could not be barred from continuing to serve clients with whom she had a prior relationship or those with whom she did not work while employed with plaintiff employer. Significantly, however, the Fourth Department strayed from the Court of Appeals' decision in BDO Seidman to "blue pencil" the restrictive covenant at issue and compel compliance to the extent the court deemed it enforceable.

The Fourth Department first quoted BDO Seidman's observation that "partial enforcement may be justified 'if the employer demonstrates an absence of overreaching, coercive use of dominant bargaining power, or other anti-competitive misconduct, but has in good faith sought to protect a legitimate business interest, consistent with reasonable standards of fair dealing….'" The Fourth Department also relied upon the following factors from Skavina: "Factors weighing against partial enforcement are the imposition of the covenant in connection with hiring or continued employment—as opposed to, for example, imposition in connection with a promotion to a position of responsibility and trust—the existence of coercion or a general plan of the employer to forestall competition, and the employer's knowledge that the covenant was overly broad."

The Fourth Department then took a particularly severe and rigid approach in determining whether the employer had met its burden, relying heavily upon Skavina, where the Third Department refused to blue pencil the agreement in question. The Fourth Department found it significant that the employee "was not presented with the [employment agreement] until her first day of work with plaintiffs, after [she] already had left her previous employer." The court also noted: "Plaintiffs have made no showing that, in exchange for signing the [employment agreement], [employee] received any benefit from plaintiffs beyond her continued employment." The court also found it damning that the employer had required the employee to sign the agreement seven years after BDO Seidman was decided, thereby showing that the employer had been on "notice" that its agreement was "overly broad."

Most severe was the manner in which the Fourth Department rejected the employer's argument that the agreement should be blue penciled because the agreement itself provided, as many such restrictive covenants do, that if any portion were deemed to be unenforceable, the court shall modify the agreement to render it enforceable. The court sternly commented that "allowing a former employer the benefit of partial enforcement of overly broad restrictive covenants simply because the applicable agreement contemplated partial enforcement would eliminate consideration of the factors set forth by the Court of Appeals in BDO Seidman, and would enhance the risk that 'employers will use their superior bargaining position to impose unreasonable anti-competitive restrictions uninhibited by the risk that a court will void the entire agreement, leaving the employee free of any restraint.'" In fact, remarkably, the Fourth Department found that including such a provision providing for modification by the courts actually demonstrated the employer's bad faith, showing that it knew the agreement was overbroad.

Under the Fourth Department's analysis—refusing to enforce, in its entirety, the restriction there as a matter of law—very few, if any, restrictive covenants would be blue penciled to save those portions that are deemed enforceable or to narrow them as written to enforce them only to the extent permissible. In reversing the Fourth Department, the Court of Appeals appears to have restored the practical availability of judicial blue penciling.

Court of Appeals Decision

On appeal, the Court of Appeals agreed with the Fourth Department that Florida law on restrictive covenants was "truly obnoxious" and offensive to New York's fundamental public policy in determining the enforcement of employment restrictive covenants. In comparing a Florida statute (Fla. Stat §542.335) that specifically required courts to view a number of factors in favor of employers, the Court of Appeals provided a handy summary of relevant New York law, including the meaningful differences with Florida law.

After noting that both states "require restrictive covenants to be reasonably limited in time, scope and geographical area, and to be grounded in a legitimate business purpose," the Court of Appeals summarized the principles of New York law that differed from Florida law: (a) "under New York's three prong test, '[a] restraint is reasonable only if it: (1) is no greater than is required for the protection of the legitimate interest of the employer, (2) does not impose undue hardship on the employee, and (3) is not injurious to the public. A violation of any prong renders the covenant invalid'" (emphasis original); (b) "New York requires the employer to prove all three prongs of its test before the burden shifts" to the employee to prove the agreement should not be enforced; (c) New York "courts [must] consider, as one of three mandatory factors, whether the restraint 'impose[s] undue hardship on the employee'"; and (d) "New York law provides that '[c]ovenants not to compete should be strictly construed because of the "powerful considerations of public policy which militate against sanctioning the loss of a [person's] livelihood.'"

The Court of Appeals concluded: "Considering Florida's nearly exclusive focus on the employer's interests, prohibition against narrowly construing restrictive covenants, and refusal to consider the harm to the employee—in contrast with New York's requirements that courts strictly construe restrictive covenants and balance the interests of the employer, employee and general public—defendants met their '"heavy burden" of proving that application of Florida law [to the non-solicitation provision of the parties' agreement] would be offensive to a fundamental public policy of this State.'"

The Court of Appeals then went on to reverse the Fourth Department's ruling refusing to blue pencil the covenant at issue as a matter of law. The Court of Appeals noted: "Under New York law, the restrictive covenant was overbroad to the extent that it prohibited [employee] Johnson from working with any of plaintiffs' New York customers, even those Johnson had never met, did not know about and for whom she had done no work." (Incidentally, while this ruling is perfectly consistent with the court's own holding in BDO Seidman, as the Court of Appeals itself acknowledged in that same decision, where there are independent legitimate interests of employers at issue, such as where trade secrets are being misappropriated, unfair competition is present or where the employee is deemed "unique," covenants could potentially be enforced even over clients or customers with whom employees had prior relationships or with whom they never worked while employed by the plaintiff. See, e.g., Arthur J. Gallagher & Co. v. Marchese, 96 A.D.3d 791, 946 N.Y.S.2d 243 (2d Dept. 2012) and 1 Model Management v. Kavoussi, 82 A.D.3d 502, 918 N.Y.S.2d 431 (1st Dept. 2011) (both citing BDO Seidman).)

In any event, the Court of Appeals in Brown reiterated that it "has 'expressly recognized and applied the judicial power to sever and grant partial enforcement for an overbroad employee restrictive covenant.'" The court then emphasized that this requires '"a case specific analysis, focusing on the conduct of the employer in imposing the terms of the agreement.'"

Noting that the case was still in its early stages, with very little discovery, the court found there were numerous factual issues that should be explored, thereby barring summary judgment: "Here, although the covenant was imposed as a requirement of Johnson's initial employment and was not presented to her until her first day of work, the parties

dispute whether she understood the agreement, whether plaintiffs' employee discussed or explained it to her, what such a discussion entailed, whether she was required to sign it that day, or if she could have sought advice from counsel and negotiated the terms of the agreement." The court also noted that the employee "had already left her prior employment—which could have caused her to feel pressure to sign the agreement rather than risk being unemployed."

Lessons

The Court of Appeals' reversal in Brown breathes renewed life into the blue pencil doctrine, rejecting the rigid approach applied by the Fourth Department. It also provides employers with a road map in dealing with the presentation and signing of restrictive covenants by employees:

1. Consider limiting restrictive covenants that prevent soliciting or serving customers to only those with whom the employee had no prior relationships and with whom the employee is introduced by the employer, or establish in what respects the prior relationships were enhanced or developed at the expense of the new employer.
2. Consider presenting the form of restrictive covenant agreement to prospective employees before offers of employment are extended.
3. Document that the employee understood the agreement, was given time to review it, had the opportunity to seek counsel and had the right to negotiate changes, all before signing.
4. Be prepared to establish independent legitimate interests that are entitled to protection in addition to or apart from customer relations, such as trade secrets, proprietary information, confidential information and/or where the employee is unique or special.

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