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Time to Revise Employment Restrictive Covenants

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Creating and maintaining employment restrictive covenants cannot be a static process. Rather, as with many contracts involving various subject matters, lawyers tasked with drafting and implementing the documents are well-advised to stay abreast of the latest case law developments to enhance the intended meaning and enforceability of those contracts.[1]

While case law determining whether and to what extent employment restrictive covenants are enforceable is certainly inconsistent and unpredictable, the courts continue to provide instructive pronouncements and observations. Lawyers who ignore such developments do so at their peril. The Fourth Department's recent decision in *Brown & Brown v. Johnson*, 980 N.Y.S.2d 631 (4th Dept. 2014) provides a font of information regarding the drafting and implementation of employment restrictive covenants. In fact, the decision stands as a stark warning to employers—rethink and revise your restrictive covenant agreements and procedures or your agreements may not be worth the paper they are written on.

Johnson Decision

The facts in *Johnson* were as typical and commonplace as these cases come. 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. As described by the court, the employment agreement was presented to the employee on the first day of work 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 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 Fourth Department's decision was in the context of defendants' motion for summary judgment, which the court below granted in part, dismissing certain of the causes of action. After determining that the choice-of-law provision in the agreement setting Florida law as applicable was unenforceable because Florida's law was "truly obnoxious" to New York's public policy governing employment restrictive covenants, the Fourth Department made a number of important findings that should be carefully considered by employers intent on effectively protecting their legitimate business interests.

The court addressed an issue that has caused some confusion and disagreement in New York—whether there is a per se rule that an employer may not enforce its restrictive covenants if it terminated its employee without cause. The principal case most relied upon by defendant employees for such an argument is the Court of Appeals' decision in *Post v. Merrill Lynch, Pierce, Fenner & Smith,* 48 N.Y.2d 84, 421 N.Y.S.2d 847 (1979). In *Post*, the court held that under the so-called "employee choice doctrine" an employer can enforce post-employment restrictions without applying the usual reasonableness analysis if the agreement was given in exchange for post-employment benefits to which the employee would otherwise not be entitled.

The court ruled that "[w]here the employer terminates the employment relationship without cause…his action necessarily destroys the mutuality of obligation on which the covenant rests as well as the employer's ability to impose a forfeiture." Some have argued that this somehow created a bright-line rule that all employment restrictive covenants are unenforceable if the employer terminates the employee without cause.[2]

The Fourth Department in *Johnson* rejected defendants' reliance on *Post*, commenting that it was strictly limited to the "forfeiture-for-competition clause situation." The court flatly ruled that even if the employee "was terminated without cause,…such termination would not render the restrictive covenants…unenforceable." The court also instructed that its decision in *Eastman Kodak Co. v. Carmosino,* 77 A.D.3d 1434, 909 N.Y.S.2d 247 (4th 2010) "did not extend the Post holding to establish a per se rule that involuntary termination without cause renders all restrictive covenants unenforceable." The court's definitive holding in this regard should provide strong guidance and settle much confusion and uncertainty in the context of employee terminations without cause.

The court in *Johnson* then addressed another ubiquitous area of dispute—the extent to which an employee can be barred from soliciting or providing services to the employer's customers post-employment. The court relied heavily upon two decisions on point—*BDO Seidman v. Hirshberg*, 93 N.Y.2d 382, 690 N.Y.S.2d 854 (1999) and *Scott, Stackrow 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 with whom his employer introduced him during the employment relationship, rather than those clients with whom he had a previous relationship.

While the court in *Johnson* applied the same analysis to the non-solicitation provision there, significantly, it strayed from *BDO Seidman's* decision to "blue pencil" the restrictive covenant at issue and enforce it partially to the extent the court deemed it enforceable. Instead, the Fourth Department in *Johnson* followed the harsh approach applied by the Third Department in *Skavina*, refusing to enforce the non-solicitation provision in its entirety and declining to "blue pencil" it to save that portion that would have been acceptable.

The Fourth Department 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 then relied heavily upon *Skavina* in determining whether the employer had met its burden, noting that *Skavina* found that: "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."

Applying the above standards, the court in *Johnson* 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."

The court in *Johnson* also rejected the employer's argument that the agreement should be blue penciled because the agreement itself provided, as many such restrictive covenants do, that in the event any portion were deemed to be unenforceable, the court had authority to 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 court found that including such a provision allowing

for modification by the courts actually demonstrated the employer's bad faith, showing that it knew the agreement was overbroad.

Finally, the court in *Johnson* addressed yet another common area in these cases apart from protecting customer relations—enforcing confidentiality provisions and attempting to prevent the misappropriation of trade secrets. In that regard, the court noted that the "information that plaintiffs seek to protect does not merely consist of 'compilations of customer names and addresses or phone numbers,'" finding that there were issues of fact regarding "whether the confidentiality covenant was necessary to protect plaintiffs' legitimate business interests, and whether [employee] violated the confidentiality covenant or misappropriated plaintiffs' trade secrets."

Lessons Learned

The Fourth Department's decision in *Johnson* obviously will not be the last word on these issues, and it is likely that since these lawsuits are decided on a case-by-case basis, other courts will render seemingly contrary findings. Nevertheless, ignoring the observations of the court in *Johnson* would not be prudent.[3] Indeed, the lessons gleaned from the court's analysis can be easily implemented, including as follows:

- Employers should pay careful attention to how they title, describe or refer to their employment agreements and what they are intended to protect. For example, the commonly used words "non-competition," "non-compete," and "non-solicitation," have a natural tendency to invoke the much-cited view that such agreements should be scrutinized because they ostensibly seek to prevent any competition or legitimate livelihoods and are therefore "disfavored."

  Indeed, preventing good, old-fashioned competition is often viewed as downright un-American. Why not eliminate that subliminal negative bias, therefore, by referring to the agreements by what they truly intend to protect and prevent? That sounds like a "business protection agreement" or an "agreement barring unfair competition"…perfectly appropriate goals.

- Similarly, the employer should include comprehensive recitals in its employment agreements, explaining the appropriate business reasons for requiring the agreement (i.e., to protect its legally recognized legitimate interests, such as to prevent unfair competition, the exploitation of its hard-earned customer relationships and the misappropriation of its trade secrets and other confidential information). The recitals should describe the time, expense and effort that the employer expended in achieving those aspects of its business that truly do deserve protection.

- Consider limiting those aspects of the agreement seeking to prevent employees from soliciting or accepting business from customers to only those customers with whom the employee was introduced or developed relationships at the employer's expense and/or through the employer. Moreover, even if the employee had prior relationships with certain customers, it is likely that those relationships were or will be enhanced through the new employer's time and effort, which also should be mentioned. Naturally, employers should consider other limitations to make sure the agreement focuses on preventing unfair, rather than any, competition.

- Consider presenting prospective employees with the employer's standard form of employment agreement before the prospective employee actually accepts employment. The court in *Johnson* found fault with the employer because it had presented the employment agreement only after the employee had decided to leave her prior employment and accept the position.

  In those situations where the prospective employee is still employed elsewhere, providing the form of agreement before the offer is accepted is likely to mitigate or avoid the court's disdain as in Johnson. Furthermore, to the extent possible, conferring benefits upon the employee in consideration of signing the restrictive covenants will enhance their status and enforceability.

The most important lesson of all, however, is to continue to stay abreast of the latest developments and rethink and adjust to take advantage of new insight.

Endnotes:

1. See, e.g., K. Schlosser, "Grappling with Fiduciary Duties in Enforcing Contracts," NYLJ, Oct. 27, 2011; K. Schlosser, "Courts Bolster Release of Fiduciary Duty and Fraud," Nassau Lawyer, April 16, 2013.

2. See, e.g., J. Coleman, "New York's Bright Line View on Non-Compete Agreements," NYLJ, April 4, 2005; see also discussion in 4A N.Y. Prac., Com. Litig. in New York State Courts §72:38 (3d ed. 2013).

3. Indeed, the court's reasoning in *Johnson* was recently followed by the federal District Court in *Veramark Technologies, Inc. v. Bouk,* 14-cv-6094 EAW, NYLJ 1202650165181, at *1 (WDNY, Decided April 2, 2014).

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