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Are Restrictive Covenants Enforceable Against Employees Terminated Without Cause?

'Hyde' indicates the answer may be yes.

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In recent years, New York courts repeatedly have held that post-employment restrictive covenants (including non-competition and non-solicitation-of-customers provisions) are per se unenforceable when the employer seeking to enforce the covenants has discharged the employee without cause. In doing so, these courts relied on *Post v. Merrill Lynch, Pierce, Fenner & Smith*,[1] a case in which the New York Court of Appeals held that when an employee is terminated without cause, and thereafter enters into competition with his or her former employer, it would be unreasonable as a matter of law to enforce an agreement providing that the employee forfeit previously earned pension benefits based on such competition. But the Second Circuit's recent decision in *Hyde v. KLS Prof'l Advisors Grp.*,[2] suggests that the lower courts have extended the ruling in *Post* beyond its intended limitation to the forfeiture-of-benefits-for-competition context, and may indicate an end to the automatic rule that restrictive covenants are unenforceable when an employment relationship is terminated without cause.

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'Post'

In *Post*, Merrill Lynch terminated two employees without cause. The employees then accepted employment with a company that competed with Merrill Lynch. Merrill Lynch informed the employees that, by accepting such competitive employment, they had forfeited their rights under the company-funded pension plan (which contained a forfeiture-for-competition provision).[3] The employees then sued Merrill Lynch for breach of contract.

Reversing the decision of the First Department, the Court of Appeals held that a forfeiture-for-competition provision is unenforceable as a matter of law when an employer has terminated the employment relationship without cause. The court reasoned that the employer's unwillingness to continue to employ an employee with a covenant not to compete "necessarily destroys the mutuality of obligation on which the covenant rests as well as the employer's ability to impose a forfeiture. An employer should not be

permitted to use offensively an anticompetition clause coupled with a forfeiture provision to economically cripple a former employee and simultaneously deny other potential employers his services."[4]

The *Post* court contrasted its holding to the prior decision in *Kristt v. Whelan*,[5] where the First Department had held that forfeiture-for-competition provisions are enforceable without regard to the reasonableness of the forfeiture at issue when the employee voluntarily "chooses" to resign and compete. In that context, the "employee choice doctrine" applied: When the employee voluntarily resigns, it is his or her choice to either (1) keep the benefits by not competing, or (2) forfeit the benefits and compete. Under the employee choice doctrine, whether the forfeiture itself is "reasonable" is irrelevant.

In 'Morris,' the Court of Appeals' clear message was that where an employee is terminated without cause or constructively discharged, the employee choice doctrine does not apply, and whether a forfeiture-for-competition provision will be enforced depends on whether the forfeiture is reasonable.

'Morris'

In *Morris v. Schroder Capital Mgmt. Int'l*,[6] the Court of Appeals reinforced the limitation of the employee choice doctrine to the forfeiture-for-competition context. In *Morris*, a former employee (Morris) commenced a breach of contract action against his former employer (Schroder) for failure to pay deferred compensation benefits. The Southern District dismissed his complaint, finding that Morris had forfeited his right to the benefits because he had resigned his job and then accepted a new job in competition with Schroder. Morris argued that the "employee choice doctrine" should not apply because Schroder was no longer willing to employ him in the same or a comparable job. The Southern District held that the proper standard to determine whether Morris voluntarily resigned—and thus whether the employee choice doctrine applied—was whether Morris had been constructively discharged. The court found that Morris was not constructively discharged, and thus that his competitive activities rightly resulted in the forfeiture of his deferred compensation benefits under the employee choice doctrine.[7] On appeal, the Second Circuit asked the New York Court of Appeals to answer the question of whether a constructive discharge constitutes an involuntary termination without cause for purposes of the employee choice doctrine. The Court of Appeals answered this question in the affirmative.[8]

An employee is "constructively discharged" when an employer purposely makes an employee's work environment so intolerable that the employee feels compelled to resign. In *Morris*, the Court of Appeals held that making the workplace unbearable for an employee—thereby forcing the employee to resign—is tantamount to a termination without cause. The *Morris* court, quoting from *Post*, confirmed that "[a]n essential element to the doctrine is the employer's 'continued willingness to employ' the employee. Where 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.'"[9] The Court of Appeals' clear message was that where an employee is terminated without cause or constructively discharged, the employee choice doctrine does not apply, and whether a forfeiture-for-competition provision will be enforced depends on whether the forfeiture is reasonable.

'SIFCO Indus.' and 'In re UFG'

A number of lower courts have interpreted the language in *Post* and *Morris* to mean that, even outside the context of the employee choice doctrine, there is a per se rule against enforcing a restrictive covenant where an employer discharges an employee without cause.[10] In *SIFCO Indus. v. Advanced Plating Techs.*, for example, SIFCO, as part of its purchase of another entity, terminated the employment of multiple employees of the purchased entity. The terminated employees, after three months of unemployment, formed a new, competitive entity. SIFCO filed suit, seeking to enforce non-competition provisions that purported to prevent the former employees from competing in the electroplating business for two years. Relying on *Post*, the Southern District held that, because the former employees had been terminated without cause, "as a matter of New York law, the Agreements are unenforceable."[11] As a result, the court did not reach the issue of the covenant's reasonableness. Upon finding that the employee was terminated without cause, the court's inquiry was over.

Four years later, in *In re UFG Int'l*, the Southern District again relied on *Post* in holding that "an employee's otherwise enforceable restrictive covenant is unenforceable if the employee has been terminated involuntarily, unless the termination is for cause."[12] As a result of decisions such as *SIFCO* and *In re UFG*, New York courts essentially adopted a bright-line test: If an employee was terminated without cause, the non-competition agreement was per se unenforceable; if an employee voluntarily resigned, or the employer terminated the employee for cause, then the court would conduct a "reasonableness" analysis to determine the enforceability of the covenant.

The seminal Court of Appeals decision regarding how to determine a restrictive covenant's "reasonableness" is *BDO Seidman v. Hirshberg*.[13] Under *BDO Seidman*, courts will find that post-employment

restrictive covenants are reasonable, and therefore enforceable, where (1) they are no greater than is necessary to protect the legitimate interests of the employer; (2) they do not impose undue hardship on the employee; and (3) they are not injurious to the public.[14] The decisions in *SIFCO* and *In re UFG* ignored this analysis and instead focused on the reason for the termination of the employment relationship, rather than the reasonableness of the covenant sought to be enforced. This created a two-part test for non-competition cases. First, a court needed to determine whether the employee was terminated without cause (or constructively discharged). If so, the covenant was per se unenforceable, and no further analysis was necessary. If not, then the court proceeded to the second step, namely, determining whether the covenant was reasonable.

'Arakelian'

The reach of this per se rule grew in 2010 due to the Southern District's decision in *Arakelian v. Omnicare*.[15] In *Arakelian*, a former employee (Arakelian) brought an action alleging, in part, that her former employer (Omnicare) failed to provide severance benefits and pay her for unused vacation time after she was discharged without cause. Arakelian also sought a declaratory judgment that the non-compete and non-solicitation provisions in a restrictive covenant agreement she entered with Omnicare were unenforceable. Notably, Omnicare apparently conceded that covenants not to compete are unenforceable under New York law when an employee has been terminated without cause. Relying on *Post* and *Morris*, the *Arakelian* court held that, because Omnicare had terminated Arakelian without cause, none of the post-employment restrictions were enforceable, including the non-solicitation-of-customers provision:

> Enforcing a noncompetition provision when the employee has been discharged without cause "would be 'unconscionable' because it would destroy the mutuality of obligation on which a covenant not to compete is based."… This rationale applies with equal force to covenants not to solicit a former employer's clients and employees; solicitation is simply a form of competition.[16]

Under *Arakelian*, therefore, employers in New York who terminate employees without cause automatically would lose the ability to enforce both non-competition and non-solicitiation agreements.

'Hyde'

The Second Circuit's recent decision in *Hyde v. KLS Prof'l Advisors Grp.*, however, questions the validity of this per se rule. In *Hyde*, a former employee (Hyde) sought to enjoin his former employer (KLS) from enforcing a restrictive covenant that prohibited him from contacting past, present and potential clients for three years following the termination of his employment. The Southern District granted a preliminary injunction against KLS, relying on the per se rule that such covenants are unenforceable when an employee is terminated without cause. The Second Circuit vacated the decision, finding that Hyde failed to establish irreparable injury—a prerequisite for such injunctive relief. Hyde had alleged that if KLS were able to enforce his post-employment restrictions, it would hinder his ability to find a new job. Citing U.S. Supreme Court and Second Circuit precedent, the *Hyde* court stated that difficulty finding new employment is not an "irreparable injury" because, if Hyde prevailed at trial, monetary damages would adequately compensate him for any harm.[17]

In remanding the case to the district court, the Second Circuit, "[i]n the interest of judicial economy" noted its "reservations" about the district court's preliminary determination that restrictive covenants are per se unenforceable in New York against an employee who had been discharged without cause. The Second Circuit suggested that in reaching this conclusion, the district court had misinterpreted *Post*, and that *Post* should be limited to the forfeiture-for-competition context. The Second Circuit "caution[ed] the district court against extending *Post* beyond its holding" and suggested that in other contexts, including when an employee has been discharged without cause, the enforceability of a restrictive covenant should be analyzed under *BDO Seidman*'s reasonableness test.[18]

Conclusion

Hyde may provide ammunition to employers seeking to enforce post-employment restrictions against employees who have been terminated without cause. Employers may have legitimate reasons for discharging an employee that an employment contract or court may not recognize as "cause" (e.g., unsatisfactory performance or economic necessity). The holdings in cases such as *SIFCO*, *In re UFG* and *Arakelian* required employers to make a choice—retain the employee, or terminate and lose any ability to enforce post-employment restrictions. *Hyde* indicates that employers may no longer be placed in such a position. *Hyde* suggests that even when the employer discharged the employee without cause, courts should conduct the *BDO Seidman* reasonableness analysis to determine whether a post-employment restrictive covenant is enforceable. In conducting this analysis, courts may consider the nature of the employee's termination a relevant factor, but not a dispositive one.

1. 48 N.Y.2d 84 (1979).
2. No. 12-1484-cv, 2012 U.S. App. LEXIS 21111 (2d Cir. Oct. 12, 2012).
3. *Post*, 48 N.Y.2d at 87.
4. Id. at 89.
5. 164 N.Y.S.2d 239 (1st Dep't 1957), aff'd, 5 N.Y.2d 807 (1958).
6. 7 N.Y.3d 616 (2006).
7. *Morris*, 7 N.Y.3d at 619-20.
8. Id. at 622.
9. Id. at 621, quoting *Post*, 48 N.Y.2d at 89.
10. See, e.g., *SIFCO Indus. v. Advanced Plating Techs.*, 867 F. Supp. 155 (S.D.N.Y. 1994); *Nisselson v. DeWitt Stern Grp. (In re UFG Int'l.)*, 225 B.R. 51 (S.D.N.Y. 1998); *Evolution Mkts. v. Penny*, No. 7823/09, NY Slip Op 51019(U) (N.Y. Sup. Ct. Westchester County May 20, 2009); *Grassi & Co., CPAs v. Janover Rubincott*, No. 015743/2008, 2009 NY Slip Op 32620(U) (N.Y. Sup. Ct. Nassau County Oct. 26, 2009); *Arakelian v. Omnicare*, 735 F. Supp. 2d 22 (S.D.N.Y. 2010); *Eastman Kodak v. Carmosino*, 77 A.D.3d 1434 (1st Dep't 2010).
11. *SIFCO Indus.*, 867 F. Supp. at 159.
12. *In re UFG Int'l.*, 225 B.R. at 55.
13. 93 N.Y.2d 382 (1999).
14. Id. at 388-92.
15. 735 F. Supp. 2d 22.
16. Id. at 41, quoting *Morris v. Schroder Capital Mgmt. Int'l.*, 445 F.3d 525, 529-30 (2d Cir. 2006) (internal citations omitted).
17. 2012 U.S. App. LEXIS 21111, at *5.
18. Id. at *6-7.