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BDO Seidman Continues To Rule NY Restrictive Covenants

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There is a tendency for lawyers to draft employment agreements containing restrictive covenants as if they are writing on a tabula rasa.[1] In New York, they are not: the Court of Appeals seminal 1999 case BDO Seidman v. Hirshberg explains what is a reasonable restrictive covenant. Although draconian restrictive covenants may have the desired in terrorem effect, many of them will not be judicially enforceable.[2] This note will discuss BDO, Ticor Title Ins. Co. v. Cohen, 173 F.3d 63 (2d Cir. 1999), decided by the Second Circuit within weeks of BDO, and several recent cases and the related, also disfavored doctrines of misappropriation of trade secrets and inevitable disclosure under New York law.

Restrictive Covenants in New York

Ticor v. Cohen

Ticor v. Cohen is notable for its holding that the services of a sales person, under the appropriate circumstances, can be deemed unique.[3]

Cohen, a 17 year Ticor star salesman, was one of its highest paid title insurance salespeople. Cohen retained his own counsel who negotiated and drafted his six months post-Ticor covenant, which restricted him from working on title insurance for sales originating in New York. He joined a competitor, and before doing so, admittedly spoke to 20 customers, generally real estate lawyers at major firms, telling them that he was considering leaving Ticor. He asked one of those clients to follow him, and inquired of others whether they would be willing to do so.

The district court entered a temporary restraining order and then an injunction enjoining Cohen from working in the title insurance business and from appropriating Ticor’s corporate opportunities with current or prospective customers for the six months of his noncompete. The Court of Appeals affirmed on the grounds that he had a unique relationship with Ticor, without deciding whether he possessed and misused Ticor confidential information.

The Second Circuit discussed the common law of restrictive covenants going back to England in 1711, and summarized New York law as follows:

Because of strong public policy militating against the sanctioning of a person's loss of the ability to earn a livelihood, New York law subjects a noncompete covenant by an employee to 'an overriding limitation of reasonableness' which hinges on the facts of each case. Assuming a covenant by an employee not to compete surmounts its first hurdle, that is, that it is reasonable in time and geographic scope, enforcement will be granted to the extent necessary: (1) to prevent an employee's solicitation or disclosure of trade secrets, (2) to prevent an employee's release of confidential information regarding the employer's customers or (3) in those cases where the employee's services to the employer are deemed special or unique.'[4]

BDO Seidman v. Hirshberg

BDO Seidman is the starting point for understanding whether a restrictive covenant will be deemed reasonable in New York. The appeal, by permission of the Court of Appeals, followed affirmance by the Fourth Department of the grant of summary judgment by Supreme Court dismissing the complaint, 247 A.D.2d 923, 688 N.Y.S.2d 537 (4th Dep't 1998).[5]

CPA Jeffrey Hirschberg, upon being promoted to manager (a step below partner) in BDO's Buffalo office, was required to sign a "Manager's Agreement" in which he expressly acknowledged that a fiduciary relationship existed with BDO by reason of his having received various disclosures which would give him an advantage in attracting BDO clients. Accordingly, if within 18 months following his termination of employment he served any former client of BDO's Buffalo office, he would compensate BDO "for the loss and damages suffered" by paying BDO, in five annual installments, an amount equal to one-and-a-half times the fees BDO charged that client over the last fiscal year the client retained BDO.

After Hirschberg left BDO for another firm, BDO claimed it lost 100 former clients who were billed a total of $138,000 the year he left. Hirschberg denied serving some of those clients and claimed that others were either personal clients he brought to the firm or clients who had other primary BDO representatives, and moved for summary judgment. BDO, on its cross motion for summary judgment, did not claim that Hirschberg actually solicited any former clients or that he used confidential information in acquiring BDO clients.[6] The Supreme Court granted summary judgment dismissing the complaint, and the Fourth Department affirmed: "Because the restrictive covenant in this agreement is overbroad, it is unreasonable and unenforceable." It agreed with the lower court's refusal to modify the agreement by severing, or "blue penciling," the unenforceable portions because "the court would thereby be required to rewrite the entire covenant."

The Court of Appeals began its discussion by noting:

The modern, prevailing common law standard of reasonableness for employee agreements not to compete applies a three-pronged 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.

New York has adopted this prevailing standard of reasonableness in determining the validity of employee agreements not to compete. 'In this context a restrictive covenant will only be subject to specific enforcement to the extent that it is reasonable in time and area, necessary to protect the employer's legitimate interests, not harmful to the general public and not unreasonably burdensome to the employee.'

In general, we have strictly applied the rule to limit enforcement of broad restraints on competition.

The court then observed that accountancy “has all the earmarks of a learned profession.” It agreed that in the context of agreements between professionals, who are deemed to provide unique or extraordinary services, the court historically gave greater weight to the employer’s interest in restricting competition within a confined geographic area. However, it nevertheless concluded that the covenant was overbroad in some respects.

It rejected BDO’s claim that it was entitled to protect its entire customer base:

BDO’s legitimate interest here is protection against defendant’s competitive use of client relationships which BDO enabled him to acquire through his performance of accounting services for the firm’s clientele during the course of his employment. Extending the anti-competitive covenant to BDO’s clients with whom a relationship with defendant did not develop through assignment to perform direct, substantive accounting services would, therefore, violate the first prong of the common-law rule: it would constitute a restraint ‘greater than is needed to protect’ these legitimate interests.

The court therefore concluded that to the extent the agreement required Hirshberg to compensate BDO for lost patronage of clients with whom he never acquired a relationship through the direct provision of substantive accounting services it was unenforceable. Because the goodwill of his personal clients who came to BDO solely to avail themselves of his services and only as a result of his own independent efforts was not acquired through the expenditure of BDO’s resources, the firm had no legitimate interest in preventing him from competing for those clients as well.

However, unlike the lower courts, the Court of Appeals held that the restraint on serving BDO clients for whom he had performed services in the Buffalo office for 18 months was reasonable and should have been partially enforced because it did not violate the second two prongs: undue hardship on employee or injurious to the public. After discussing the case law, it concluded that partial enforcement may be justified where, as in this case, “the employer demonstrates an absence of overreaching, coercive use of dominant bargaining power, or other anti-competitive conduct” and has acted in good faith to protect a legitimate business interest. Accordingly, the court remitted to determine which former BDO clients were properly within the covenant.

The court said the provision requiring defendant to compensate BDO in an amount equal to one-and-one-half times the fees charged over the last full year the client was served by BDO was a classic liquidated damages provision. As such, it was black letter law that unless the actual damages flowing from a breach would be difficult to ascertain, and the amount fixed is a reasonable measure of the anticipated probable harm, the clause would be a penalty and would not be enforced. The court agreed that damages in this instance would be sufficiently difficult to ascertain to meet the first prong, but found the record was insufficient to establish that the amount fixed was not so excessive to actual damages as to constitute a penalty, and remitted on this ground as well.[7]

Brown & Brown v. Johnson

One of the most recent appellate decisions on point is another Fourth Department case, Brown & Brown Inc. v. Johnson, 980 N.Y.S.2d 631 (4th Dep’t 2014). After four years, Brown terminated actuary Theresa Johnson, who thereafter went to work for a competitor. Brown sued Johnson along with her new employer, for violating her employment agreement.

The agreement provided for application of Florida law. A Florida statute expressly forbids courts from considering the hardship imposed upon an employee in evaluating the reasonableness of a restrictive covenant. Although Florida did bear a reasonable connection to the dispute in that Brown's corporate parent is a Florida corporation with its principal place of business in Florida and the parent corporation played a role in Brown's management and administration, the Fourth Department concluded that the choice of law provision was unenforceable and that it would apply New York law. Under New York law, a restrictive covenant that imposes an undue hardship on the employee is invalid and unenforceable for that reason (citing Welsbach Elec. Corp. v. MasTec North America Inc., 7 N.Y.3d 624, 629 (2d Dep't 2006) and BDO). The court concluded that Florida law was "truly obnoxious" to New York public policy.

Johnson had agreed: (1) not to solicit or service any client of Brown's New York offices for two years following termination; (2) not to disclose Brown's confidential information or use it for her own purposes; and (3) not to induce Brown's New York employees to leave their employment for two years after Johnson's termination.[8]

As to the first provision, the Fourth Department agreed that the nonsolicitation covenant was overbroad and unenforceable as a matter of law because it sought to bar Johnson from soliciting or providing services to Brown clients with which she never acquired a relationship. It also refused to partially enforce the provision, to prevent Johnson from soliciting and servicing only clients with which she had a relationship. The court noted that Brown presented the employment agreement to Johnson more than seven years after the BDO decision, which "served as notice to plaintiff that the agreement at issue here was also overly broad." Although the agreement provided for partial enforcement if a court found the covenants overly restrictive, the court concluded that rather than demonstrate the absence of overreaching, that provision demonstrated that Brown imposed the covenant in bad faith, knowing that it was overbroad.

As to the second provision regarding confidentially, the court modified the grant of summary judgment in favor of Johnson. It noted that it is generally a question of fact whether information sought to be protected is confidential or constitutes a trade secret, and there was some evidence that the information at issue was more than compilations of customer names, addresses and phone numbers, which would not be confidential.

As to the final provision precluding inducing employees to leave Brown, the Fourth Department left standing the lower court's refusal to dismiss claims based on that provision.

Veramark v. Bouk

Veramark Technologies Inc. v. Bouk is a recent case where a federal court refused to grant a preliminary injunction against a former head of sales who joined a competitor and agreed in his employment agreement not to solicit or approach any of plaintiff's customers or employees for a year. After commencement of the litigation, Bouk confirmed in writing to his new employer that he would not disclose or use any of plaintiff's confidential information and would not solicit plaintiff's customers or employees.

The court rejected plaintiff's argument that it was entitled to the full panoply of restrictions in Bouk's employment agreement, specifically that he would not directly or indirectly perform services for any competitor anywhere in the world for one year. "A broad noncompete that baldly prevents competition will not be enforced, particularly where the employer is already protected by a nonsolicitation

agreement."

As in Brown, supra, upon which the court relied extensively, Bouk's employment agreement provided that he consented to injunctive and other equitable relief for violation of any of the restrictive covenants. The court rejected this provision as a basis for granting an injunction — "although language in an agreement may buttress a conclusion of irreparable injury, it cannot replace the necessary analysis under New York law."[9]

Misappropriation of Trade Secrets

New York is virtually the only state that has not adopted the Uniform Trade Secrets Act, first published by the Uniform Law Commission in 1979 and amended in 1985. The UTSA, among other things, defines the term "trade secret" and provides for injunctive relief, damages and attorney's fees for "misappropriation."

Accordingly, in the absence of a statute, a claim that a former employee misappropriated trade secrets is a common law violation. The essential elements are that plaintiff possesses a trade secret and defendant is using that trade secret in breach of an agreement, a confidential relationship or otherwise improperly. New York courts generally use the definition of trade secret contained in Section 757 of the Restatement of Torts: "A trade secret may consist of any formula, pattern, device or compilation of information which is used in one's business, and which gives him an opportunity to obtain an advantage over competitors who do not know or use it."

Inevitable Disclosure Doctrine

Closely related to misappropriation of trade secrets is another disfavored doctrine in New York: inevitable disclosure. The doctrine is based on the assumption that because of the similarity in the business of the former employer and the new employer, it is inevitable that the employee will disclose the trade secrets of the former to the latter, and the courts should enjoin such disclosure.

The 2003 decision of the Third Department in Marietta Corp. v. Fairhurst put the brakes on what might have developed into an expansive use of the doctrine. Southern District Judge William Pauley's decision 10 years later in Janus et Cie. v. Kahnke doomed the doctrine as an independent cause of action.

Marietta v. Fairhurst

In Marietta, the Third Department reversed a Cortland County justice, who granted plaintiff's motion for a preliminary injunction preventing Fairhurst from working for a direct competitor of Marietta, where he began working following his termination by Marietta. Fairhurst was subject to a confidentiality agreement, but not a restrictive covenant, and there was no evidence that he had intentionally disclosed any proprietary information to his new employer. Nevertheless, the lower court found that it was extremely likely that Fairhurst would use Marietta's "secrets — if only unconsciously — in carrying out his duties."

On appeal, the Appellate Division noted the well-entrenched public policy disfavoring restrictive covenants, and that the inevitable disclosure doctrine was similarly disfavored in the absence of evidence of actual misappropriation by the employee. Fairhurst was not in breach of his confidentiality agreement and there was no factual determination that the confidential information to which he was privy rose to the level of a trade secret. (See U.S. Re Cos. v. Scheerer, 41 A.D.3d 152, 155, 838 N.Y.S.2d

37, 40 (1st Dep’t 2007) citing Marietta and reversing a preliminary injunction — “Absent concrete evidence that the employee has actually breached a confidentiality agreement, there is no basis to bind him ‘to an implied in fact restrictive covenant’ not to compete.”)

Janus v. Kahnke

Kahnke had a nondisclosure agreement but no noncompete agreement with Janus, a provider of high-end furniture. He was a senior sales manager and accepted employment with a competitor. Janus, which did not allege breach of Kahnke’s nondisclosure agreement or any form of misappropriation or disclosure of trade secrets, sought an injunction on the theory that Kahnke’s new position was so similar to his old one that he could not function without using or disclosing Janus’ confidential information and trade secrets. Judge Pauley granted Kahnke’s motion to dismiss, in an opinion that makes clear the court’s disdain for the doctrine.

The court first observed that New York courts have used the inevitable disclosure doctrine only to support a required showing of irreparable harm where there is a substantial risk of disclosure to a competing employer and where there was evidence of: (1) actual misappropriation or (2) breach of a noncompete agreement.

Janus requested that the court recognize inevitable disclosure as a “stand-alone claim,” with the effect of a permanent injunction, without any allegation of misappropriation of trade secrets or breach of a noncompete agreement. The court characterized that as an “extraordinary request” that would “greatly expand the reaches of a restricted doctrine heavily disfavored under New York law.” The court cited Marietta, its prior decision in EarthWeb Inc. v. Schlack and other cases and roundly rejected the claim as against “well-entrenched state public policy considerations disfavoring such agreements.”

Takeaways

To avoid having a very unhappy client, make sure that you manage your client’s expectations early on when drafting a restrictive covenant and later when trying to enforce it. Although you and your client may “get lucky” and scare off employees and their potential employers based on the in terrorem existence of a restrictive covenant and threat of expensive and time-consuming litigation, that should be a wish and not an expectation.

First, review and revise as necessary the client’s form restrictions. If you are hoping for judicial enforcement as opposed to merely the in terrorem effect, make sure that it is apparent that the drafter was aware of current case law. Even if the client chooses not to make revisions, the document should bear a reasonably current date. One factor that persuaded the Brown and Skavina courts not to judicially modify the restrictions was that the employer had ignored the BDO “wake-up call.” Best practice suggests that, if feasible, a new employer should provide the restrictive provisions to the potential employee before he/she leaves a current employer to mitigate against a claim that the new employee had no choice and was effectively coerced to sign. Do not put in a Florida choice of law provision, regardless of Florida’s connection to the matter; Brown could not be clearer on that point. Do not assume that a court will accept at face value a liquidated damages provision, or a consent to injunctive relief or blue penciling. Courts look beyond the words in the agreement to the reality of the situation. If possible, avoid titling the provisions restrictive covenants, noncompete or nonsolicitation. We all know that these provisions are disfavored in New York and why raise a red flag over a title. Perhaps use “postemployment obligations.”

Second, on a micro level, identify the employer's legitimate interest, and then craft the covenant to be no broader than that interest, in terms of subject matter, length and geographic scope. The restriction should be directly related to the employee's duties and responsibilities; a scientist and a marketing person may both have restricted confidential information, but it is unlikely to be the same categories of information. In situations where an incoming employee is bringing his/her own clients, consider excepting those names from any restriction, which could help a court determine that the other restrictions are reasonable.

Third, make sure there is consideration for the covenant. That is not an issue if it is part of the employment agreement at the time of hire, even for an employee at will. However, if the employer is demanding a restrictive covenant during the employee's tenure, it should be in connection with a raise or promotion. If there is no employment event associated with the execution, and the document merely recites that it is in consideration of continued employment, that raises another enforcement hurdle.

Fourth, make sure the client understands that if it really wants to protect its information, it should seriously consider contracting in advance to pay for that protection. That is fairly common in British employment agreements, where it is known as "garden leave." If the employee is entitled to payment, not inconsequential compared to the regular salary, during the period of the restriction, a court is far more likely to enforce the restriction.

Finally, assuming that the employer is serious about attempting to enforce these types of agreements, it needs an action plan in place. When an employee with a restrictive covenant gives notice of his/her intention to leave, the employer should be prepared to take immediate action. That means for each employee who is under some kind of restriction, the employment file should contain a signed copy of the agreement, a pay history and, at minimum, a current explanation of why the specific restrictions are reasonable and relevant. That allows the employer to notify the employee (and perhaps the new employer) promptly, reminding the employee of the contractual obligations in place and advising of potential legal action for breach. It also means that there is a protocol established to review departing employees' electronic records to see whether there have been unusual downloads and whether the employee has been looking for a new job on company time — improper behavior which can make a major impression on a court.

These steps will enable counsel to act quickly to protect the employer's rights and perhaps permit the employer — or the employee — to negotiate a satisfactory arrangement with a potential employer. These steps also demonstrate to a court that the employer has a legitimate business interest that it takes seriously, and is attempting to minimize its potential damage.

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[1] Related to noncompete agreements is the "employee choice" doctrine. "The sense and purpose of the 'employee choice' doctrine is that an employee is given a choice in either preserving his rights under an employment contract by not competing or losing them by engaging in competition." Morris v. Schroder Capital Management Int'l, 7 N.Y.3d 616 (2006) (on certified question from the United States

Court of Appeals for the Second Circuit, 445 F.3d 525 (2d Cir. 2006)). Under the doctrine, forfeiture of compensation/clawback provisions require an employee who competes with his employer to forfeit certain benefits to which the employee otherwise would have been entitled. However, forfeitability is subject to the Employee Retirement Income Security Act's nonfortfeitability provisions if the subject plan is ERISA-governed. In the case of an involuntary discharge without cause, forfeiture is unreasonable as a matter of law, even if the employee works for a direct competitor. Post v. Merrill Lynch, Pierce, Fenner & Smith Inc., 48 N.Y.2d 84 (1979). Under Schroder Capital, the factual determination of involuntary discharge is governed by the "constructive discharge" test of federal employment discrimination law, not whether the employer is willing to employ the employee in the same or a comparable job. "In cases where an employer intentionally makes the employee's work environment so intolerable that it compels him to leave ... an employer should not be permitted to enforce an unreasonable noncompete clause and simultaneously deny the employee his benefit under the guise of the employee choice doctrine." Id. at 508. (On remand, the Second Circuit affirmed dismissal of the complaint because Morris' working conditions at Schroder, which allegedly decreased his responsibilities to such a degree that he was in a "dead-end" job with no alternative but to resign, were not so difficult or unpleasant that a reasonable person in his shoes would have felt compelled to resign. Morris v. Schroder Capital Management Int'l, 481 F.3d 86 (2d Cir. 2007)).

[2] Our Feb. 11, 2014, article, NY's Strong Restrictions on Restrictive Covenants, published in Law360, dealt with this issue in connection with our analysis of Southern District of New York Judge P. Kevin Castel's Jan. 9, 2014 decision denying preliminary injunctive relief in Reed Elsevier Inc. v. TransUnion Holding Co., 13 Civ. 8739 (Jan. 9, 2014).

As recently as June 2014, in an article entitled "Noncompetes Are Popping Up in the Strangest Places," Corporate Counsel, quoting a New York Times article, noted that event planners, chefs, investment fund managers and yoga instructors are being required to sign noncompetes, because there is no downside for an employer to insist on them; "the employer can use the threat of enforcing the noncompete without having a court ever construe its terms or determine whether it is actually enforceable."

[3] Ticor was issued two months after BDO. It did not reference that decision and assumed that the covenant was reasonable.

[4] The court focused on the third prong, assuming that the restraint was reasonable because the six months duration was relatively short and the geographic scope not overbroad. The court noted that that special or unique services was not the typical basis for an injunction in the restrictive covenant context, but agreed with the trial court that Cohen's relationships with his clients were "special" and qualified as unique services. The inquiry focused more on the employee's relationship to the business than on the individual person. It was unnecessary to test whether "such person is extraordinary in the sense, for example, of Beethoven as a composer, Einstein as a physicist or Michelangelo as an artist, where, one can fairly say that nature made them and then broke the mold." 173 F.3d at 65. Because of the facts specific to Cohen's employment, Ticor's earlier experience with a lesser salesman who took 75 percent of his business to a competitor when he resigned, and the fact that Cohen's $600,000 annual salary was sufficient to sustain him for six months, there was no public policy precluding enforcement of Cohen's bargained for restriction.

[5] The Court of Appeals articulated the central issue as "whether the 'reimbursement clause' in an agreement between the parties, requiring defendant to compensate BDO for serving any client of the firm's Buffalo office within 18 months after the termination of his employment, is an invalid and unenforceable restrictive covenant." 93 N.Y.2d at 387.

[6] The Court of Appeals noted in a footnote that "[a] different result might obtain had BDO submitted any proof that defendant had used confidential firm information to attract BDO clients with whom he had not had a relationship while employed there." 93 N.Y.2d at 398 n.2.

[7] Years later, the Supreme Court denied BDO's motion for a declaratory judgment that the liquidated damages provision was enforceable and the Fourth Department affirmed. 8 A.D.2d3d 1113, 778 N.Y.S.3d 354 (4th Dep't 2004).

In Scott, Stackrow & Co. v. Skavina, 9 A.D.3d 805, 780 N.Y.S.3d 675 (3d Dep't 2004), another accountant case, the Third Department refused to consider partial enforcement under BDO. Among the reasons for its refusal was that the firm continued to require the accountant to sign an agreement annually, after the BDO decision, "which deemed unreasonable a similar anti-competition agreement."

[8] As a preliminary matter, the court held that even assuming that Johnson was involuntarily terminated without cause, that fact would not render her covenants automatically unenforceable. As a general matter, however, New York courts are loath to enforce restrictive covenants if the employee was discharged without cause. See, e.g., Post v. Merrill Lynch, supra; Greystone Funding Corp. v. Kutner, 2013 Slip Op. 32980(U) Index No. 651926/2013 (Sup. Ct. N.Y. Co. Nov. 6, 2013) (Ramos, J.).

[9] The court recognized that violation of an enforceable noncompete constitutes irreparable harm because of the difficulty of calculating damages for loss of a client relationship (citing Ticor, 173 F.3d at 69), but even where there is an alleged threat to customer goodwill, "irreparable harm may not be presumed and must be demonstrated in each case."

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