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NY's Strong Restrictions On Restrictive Covenants

Law360, New York (February 11, 2014, 3:19 PM ET) -- District Judge P. Kevin Castel's recent decision denying preliminary injunctive relief in Reed Elsevier Inc. v.TransUnion Holding Co. Inc., 13 Civ. 8739 (PKC) (Jan. 9, 2014), is mandatory reading for New York practitioners who draft or review employment agreements.

Although the fact pattern is somewhat unique, the decision restates and reaffirms the law in New York on judicial interpretation of restrictive covenants in employment agreements.

Unlike most employment litigations, the employee was not named as a defendant. Rather, Reed Elsevier Inc., the former employer, sued only TransUnion Holding Co. Inc., the new employer. The suit was based on TransUnion's alleged violation of a "no-hire" agreement between the two companies arising out of TransUnion's earlier employment of another former REI employee.

The Facts

Armando Escalante was chief technology officer of REI's Lexis Nexis Risk Solutions division from 2004 through April 2012. Escalante left REI in May 2012 and worked for two employers that were not REI competitors before joining REI's competitor, TLO LLC. By the time Escalante accepted a position with TLO, where he became chief operating officer, Escalante's one-year noncompete under his REI employment agreement had expired, so that he was free to join a competitor.

However, in May 2013, TLO filed for reorganization under Chapter 11 of the Bankruptcy Code. On Dec. 15, 2013, TransUnion acquired substantially all of the assets of TLO in a bankruptcy auction. REI was a losing bidder. Under the terms of the auction sale, TransUnion chose to assume Escalante's contract.

Unrelated to Escalante, in December 2012, REI waived the noncompete obligations of James Peck, an even higher-level REI employee, and permitted Peck to work for TransUnion, in exchange for TransUnion's written agreement not to hire certain high-level REI employees, including Escalante (who had already left REI), until after Dec. 14, 2014 (no-hire agreement).

Although REI and TransUnion were competitors, they were also customers and suppliers to each other. REI was willing to accommodate Peck's employment at TransUnion in exchange for contractual protections from both Peck and TransUnion.

Based on the no-hire agreement, in December 2013, REI filed its complaint and moved for a temporary restraining order and preliminary injunction against TransUnion, alleging that Escalante's employment by TransUnion violated the no-hire agreement upon TransUnion's acquisition of TLO.

The complaint alleged causes of action for breach of contract, promissory estoppel and tortious interference with contract, and demanded a declaratory judgment that TransUnion's action have or will breach the no-hire agreement.

The parties agreed to limit Escalante's employment role until the preliminary injunction hearing, mooting REI's application for a temporary restraining order. Castel held an evidentiary hearing on Jan. 6, and filed his memorandum and order on Jan. 9, 2014.

The Decision Denying Injunctive Relief

Preliminarily, Castel rejected TransUnion's argument that REI's complaint and motion were impermissible collateral attacks on the TLO bankruptcy court's order approving the sale of substantially all of TLO's assets to TransUnion.

Turning to the employment issues, the court agreed that TransUnion's assumption of Escalante's contract constituted a "hire" within the scope of the no-hire agreement so that facially, the no-hire agreement applied. However, he refused to enforce it.

Citing long-standing New York law, the court began by noting that "restrictive covenants must be 'rigorously examined' and 'enforced only to the extent necessary to protect the employer from unfair competition' [based] on 'the general public policy favoring robust and uninhibited competition,' and 'powerful considerations of public policy which militate against sanctioning the loss of a man's livelihood." (citations omitted).

The court then applied the three-prong reasonableness standard analysis applied to noncompete clauses set forth in BDO Seidman v. Hirshberg, 93 N.Y.2d 382 (1999), to determine the reasonableness of the no-hire provision at issue: "In order to be enforceable, an anti-competitive covenant ancillary to an employment agreement must be reasonable in time and area, necessary to protect the employer's legitimate interests, not harmful to the public, and not unreasonably burdensome to the employee." (citations omitted).[1]

The court focused on the specific facts giving context to the no-hire agreement, as required by BDO Seidman. TransUnion conceded that the lack of any geographic limitation was not unreasonable given the worldwide scope of both parties' business, and the court agreed that the absence of any geographic limitation was not unreasonable.

However, it found that the two-year term of the no-hire agreement (and which could be read to apply to some of the named REI employees for up to 36 months after departure from REI), was unreasonable. Noting that New York courts routinely find one-year restrictions to be reasonable, and two years under certain circumstances not "unduly burdensome," the fact that this was a worldwide covenant extending 31 months after Escalante's cessation of employment with REI was unreasonable and therefore unenforceable.

While New York courts consider "blue penciling" and modifying overly restrictive covenants, it declined to do so because REI failed to demonstrate that the no-hire of Escalante was necessary to protect REI's legitimate interests.

New York law recognizes four legitimate protective interests to support a restrictive covenant: (1) trade secrets, (2) confidential customer information, (3) employer's client base, and (4) irreparable harm where the employee's services are unique or extraordinary.

REI relied on interests 1, 3 and 4, and the court rejected each. REI also tried to create a fifth category — the alleged risk on its ability to retain its current employees. The court also rejected that claim as not among the legitimate interests recognized by New York courts, ruling that the four categories were the exclusive grounds to justify restriction.

REI Failed to Establish Protection of its Trade Secrets

REI claimed that a software "platform," designed to analyze billions of records and complex data within extremely short periods of time, met the criteria of being a trade secret. However, Escalante swore that he was not involved in programming the platform and no longer had any "intricate knowledge" of its inner workings, and TransUnion submitted affidavits that neither it nor TLO used or planned to use the platform.

As to other projects that REI described as "sensitive," the court held that even if REI had proprietary trade secrets in those products, there was no evidence that Escalante was in possession of those secrets. Finally, in response to REI's argument that Escalante's strategic knowledge could harm it from a competitive standpoint, the court cited Marietta Corp. v. Fairhurst, 301 A.D.2d 734, 453 N.Y.S. 2d 62 (3d Dept. 2003), for the proposition that the "enhanced ability to market a product without, for example, a trade secret, confidential information, or intricate knowledge of the customer base, is not a protected interest."[2]

REI Failed to Establish Protection of its Customer Base

The court rejected as too speculative REI's claim of a legitimate interest in protecting its client base. Escalante's responsibilities had been managerial and supervisory rather than client-focused, REI had no evidence of client attrition, and an internal REI email suggested the likelihood of Escalante luring customers away had "low probability" and was "unlikely."

REI Failed to Establish Escalante's Services as Unique or Extraordinary

The court stated that in New York, the "standard of uniqueness is high: 'an employee is unique if his services are of such character as to make his replacement impossible or that the loss of such services would cause the employer irreparable injury.'" (citations omitted).

It noted that in New York, there are two sets of circumstances that can constitute "uniqueness": (1) musicians, professional athletes, actors and similar professionals, and (2) brokers, traders or salespersons who are unique based on their customer relationships.

The court rejected Escalante as being unique or extraordinary under either category. Not only was Escalante primarily a managerial/supervisory employee, but he was immediately replaced when he left REI, more than 18 months previously.

The Takeaway

No business is happy when it loses an important employee, especially an employee who is subject to a restrictive covenant. In these situations, clients frequently demand that counsel throw the "kitchen sink" into the legal papers, and demand immediate and extraordinary relief.

Castel's decision, combined with Judge William Pauley's recent decision in Janus et Cie v. Andrew Kahnke, R-Civ. 7201 (WHP) (S.D.N.Y. Aug. 29, 2013), rejecting the use of the "inevitable disclosure" doctrine, absent allegations of wrongdoing or breach of a noncompete agreement, are reminders — if any were necessary — that New York courts look askance at restricting an individual's ability to earn a livelihood and are not likely to go out on a limb for a jilted employer.

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[1] In BDO Seidman, upon being promoted to manager (a step below partner), Hirshberg executed an agreement acknowledging that he was in a fiduciary relationship with BDO, and agreed that if, within 18 months following the termination of his employment, he served any former client of the local BDO office, he would compensate BDO "for the loss and damages suffered" equal to 1 1/2 BDO's fees to that client over the prior year.

Hirshberg moved to another Buffalo accounting firm and BDO sued. The Supreme Court granted Hirschberg summary judgment, concluding that the clause was an overbroad and unenforceable anti-competitive agreement, and the Appellate Division agreed, holding that the entire agreement was invalid. The Court of Appeals held that the 18 month and Buffalo area restrictions were not unreasonable, but that the covenant as written was overbroad and unenforceable in two respects.

First, to the extent that Hirshberg was required to compensate BDO for lost patronage of clients with whom he never acquired a relation during his employment. Second, "it would be unreasonable to extend the covenant to personal clients of defendant who came to the firm solely to avail themselves of his services and only as a result of his own independent recruitment efforts, which BDO neither subsidized nor otherwise supported as part of a program of client development."

Whereas the intermediate appellate court had refused partial enforcement or severance of the covenant, the Court of Appeals rejected that per se approach in favor of a more flexible position; "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, partial enforcement may be justified." Therefore, the court granted plaintiff partial summary on liability, since Hirshberg conceded that some of his new clients came within the clause, as modified.

However, when it came to the liquidated damages provision in the agreement (1 1/2 the amount of BDO's fees to that client over the prior year), the court held that BDO did not meet the second prong of the test for an enforceable liquidated damages clause. Although BDO's damages flowing from the breach were difficult to ascertain, the record was insufficient to establish that the amount fixed in the agreement was not so excessive as to constitute a penalty. Because of the sparse proof as to the latter requirement, the court remitted for further development of the record on the liquidated damages formula. (Five years later, the Fourth Department affirmed the lower court's 2003 denial of BDO's motion for a declaratory judgment that the liquidated damages provision was enforceable. 8 A.D. 3d 1113 (4th Dep't 2004), 778 N.Y.S.2d 354).

[2] Marietta is primarily known as an "inevitable disclosure" case, where the Third Department reversed a decision granting the former employer a temporary restraining order and prohibiting the employee from working for a competitor for a year. "As no restrictive covenant was in existence here and our well-entrenched state public policy considerations disfavor such agreements, the doctrine of inevitable disclosure is disfavored as well, 'absent evidence of actual misappropriation by an employee.'" (citations and footnote omitted). 301 A.D.2d at 66, 754 N.Y.S.2d at 737.