Enforcing Restrictive Covenants When Terminating Employees Without Cause: Is There a Clear Rule in New York?

By Tricia B. Sherno and Steven T. Sledzik

New York employment lawyers may find it surprising that New York does not appear to have a clear rule governing whether post-employment restrictive covenants are enforceable when an employee is discharged involuntarily and without cause. Some courts have concluded that there is a *per se* rule against enforcement of restrictive covenants when a termination is without cause, while others have determined that no such *per se* rule exists. In reaching such divergent conclusions, courts have cited the same New York Court of Appeals decision from 1979, *Post v. Merrill, Lynch, Pierce, Fenner & Smith*.[1] In *Post*, the Court of Appeals held that when an employee is involuntarily terminated without cause and subsequently competes with his or her former employer, it would be unreasonable as a matter of law to enforce an agreement under which the employee would forfeit earned pension benefits because of such competition.[2] New York courts confronting *Post* have not treated it consistently.

This article will analyze *Post* and the disparate case law that has evolved from that decision. Part I of the article will present a brief overview of the legal standard governing the enforcement of restrictive covenants under New York law and the jurisdiction's employee choice doctrine, which is critical to understanding *Post*. Part II will discuss the facts of *Post* and its holding. Part III will analyze cases interpreting *Post*.

In reaching a conclusion, we struggled to find an appropriate metaphor for the divergent reasoning that has developed out of *Post.* We chose the myth of the twin brothers, Romulus and Remus, without passing judgment as to which may have been the evil twin. This metaphor, discussed in more detail in the conclusion, is apt to assist in illustrating the uncertainty as to this issue.

I. New York Law Governing Restrictive Covenants and the Employee Choice Doctrine

Restrictive covenants are generally disfavored under New York law because of public policy considerations against "sanctioning the loss of a man's livelihood."[3] However, such contracts are permissible in New York and are frequently enforced. Shaped by public policy concerns, New York follows the majority of jurisdictions in applying a reasonableness standard when examining the validity and enforceability of restrictive covenants. Specifically, as articulated by the New York Court of Appeals in *BDO Seidman v. Hirshberg*, "[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."[4]

New York courts have developed the "employee choice doctrine" as an exception to the reasonableness standard and the public policy against enforcement of restrictive covenants. Under the "employee choice doctrine," restrictive covenants are generally held to be enforceable—regardless of their reasonableness—when employees who voluntarily terminate their employment have a choice between complying with the covenant and receiving compensation or benefit, or engaging in the restricted activity and foregoing the compensation or benefit.[5] In contrast, when employees are involuntarily terminated without cause, the employee choice doctrine generally does not apply and a court must determine whether forfeiture of the compensation or benefit is reasonable.[6] The employee choice doctrine "rests on the premise that if the employee is given the choice of preserving his rights under his contract by refraining from competition or risking forfeiture of such rights by exercising his right to compete, there is no unreasonable restraint upon an employee's liberty to earn a living."[7]

Employees who voluntarily depart for a competitor could attempt to circumvent the employee choice doctrine and avoid the automatic forfeiture of benefits by arguing they were constructively discharged. In *Morris v. Schroder Capital Management International*, the New York Court of Appeals expressly held that the employee choice doctrine does not apply if an employee voluntarily quit under circumstances that rise to the level of a constructive discharge.[8] An employee is constructively discharged if an employer deliberately and intentionally creates an intolerable workplace condition to "compel a reasonable person to leave."[9] Not surprisingly, employees and employers often dispute whether or not a termination was voluntary or involuntary or with or without cause. Thus, depending on whether there are any disputed facts surrounding a termination, it may not always be clear until trial whether a court will apply the employee choice doctrine.

II. A Closer Look at the *Post* Decision

In *Post*, for the first time, the New York Court of Appeals distinguished between voluntary and involuntary terminations of employment when considering the enforceability of a forfeiture-for-competition provision in an

employee deferred compensation plan.[10] The plaintiffs, Post and Maney, were employed by Merrill Lynch as account executives.[11] Both elected to be paid a salary and to participate in the firm's pension and profit sharing plan rather than take a straight commission that would have returned approximately twice the amount they earned in salary during their employment.[12] After working for Merrill Lynch for more than a decade, both employees were terminated without cause.[13] Almost immediately after their discharge, both began working for a competitor.[14] Fifteen months after their termination, following repeated inquiries by Post and Maney as to the status of their pensions, they were informed by Merrill Lynch that all of their rights in the company-funded pension plan had been forfeited pursuant to a provision of the plan permitting forfeiture in the event an employee directly or indirectly competed with the firm.[15]

The plaintiffs brought an action against Merrill Lynch for conversion and breach of contract to recover amounts owed to them under the pension plan.[16] Merrill Lynch moved for summary judgment, and the trial court denied the motion.[17] The Appellate Division, First Department, reversed and dismissed the Complaint.[18] The New York Court of Appeals reversed the Appellate Division and reinstated the Complaint.[19]

The New York Court of Appeals held that New York policies "preclude the enforcement of a forfeiture-for-competition clause where the termination of employment is involuntary [*i.e.*, not the employee's choice] and without cause."[20] More specifically, the Court of Appeals held "that where an employee is involuntarily discharged by his employer without cause and thereafter enters into competition with his former employer, and where the employer, based on such competition, would forfeit the pension benefits earned by his former employee, such a forfeiture is unreasonable as a matter of law and cannot stand."[21] In reaching its holding the Court of Appeals reasoned:

> 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. 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.[22]

The Court reaffirmed that "[s]o potent is this policy that covenants tending to restrain anyone from engaging in any lawful vocation are almost uniformly disfavored and are sustained only to the extent that they are reasonably necessary to protect the legitimate interests of the employer and not unduly harsh or burdensome to the one restrained."[23] The *Post* Court distinguished the facts of the case from those in which an employee voluntarily leaves employment to join a competitor, thus triggering the employee choice doctrine.[24] At the outset of its opinion, the Court emphasized that its brief decision was limited to the "narrow issue" of "the efficacy of a private pension plan provision permitting the employer to forfeit pension benefits earned by an employee who competes with the employer after being involuntarily discharged."[25]

III. The Progeny of *Post*

A. Cases with a More Expansive View of *Post*

Despite the New York Court of Appeals statement that its decision in *Post* was "narrow" and applicable to "forfeiture-for-competition clauses," multiple courts have cited *Post* as authority for a *per se* rule against the enforcement of restrictive covenants when employees are involuntarily terminated. Without discussion, the Appellate Division, Second Department, has cited *Post* for the proposition that a termination without cause renders restrictive covenants unenforceable.[26] The Appellate Division, Fourth Department, has extended *Post* to stock option forfeiture provisions for employees terminated without cause who work for competitors.[27]

Additionally, three federal district court judges in the Southern District of New York (Judges Crotty and Cedarbaum and former Judge Schwartz) have concluded, relying on *Post*, that non-competition provisions are *per se* unenforceable under New York law when an employee is involuntarily terminated without cause.[28] In *SIFCO Indus. v. Advanced Plating Techs.*, the district court held that the noncompetition covenant contained in the employees' confidentiality agreements was unenforceable because the employees in question had been terminated without cause.[29] The court cited *Post* and plainly stated that "New York courts will not enforce a non-competition provision in an employment agreement where the former employee was involuntarily terminated."[30] In *In re UFG Int'l*, the court relied on *Post* and held that "an employee's otherwise enforceable restrictive covenant is unenforceable if the employee has been terminated involuntarily, unless the termination is for cause."[31] In *Arakelian v. Omnicare*, a former employee filed suit against her former employer for unpaid severance and vacation benefits after she was involuntarily terminated without cause.[32] The employee also sought a declaratory judgment that her non-competition and non-solicitation agreements signed at the commencement of her employment were not enforceable under New York law.[33] Citing *Post* and *SIFCO*, the court sided with the employee and ruled that both the non-competition and non-solicitation covenants were unenforceable as a matter of law in light of the involuntary termination.[34]

Given that the rulings in *SIFCO*, *In re UFG*, and *Arakelian* turned on whether the employee was involuntarily terminated without cause, the courts in those cases did not analyze the restrictive covenants under a reasonableness standard.

B. Cases Strictly Construing *Post*

Not all courts have agreed that a *per se* rule exists under New York law in situations when an employee is involuntarily terminated without cause. Notably, in its 2006 decision in *Morris v. Schroder Capital Management International*, the New York Court of Appeals cited *Post* and indicated that "a court must determine whether forfeiture is 'reasonable' if the employee was terminated involuntarily and without cause."[35] The Court of Appeals made no mention of any *per se* rule applicable to involuntary terminations.

More recently, in *Brown & Brown, Inc. v. Johnson*,[36] the Appellate Division, Fourth Department, rejected the argument that such a rule exists under *Post*. The Fourth Department reasoned that the *Post* holding was to "preclude the enforcement of a forfeiture-for-competition clause where the termination of employment is involuntary and without cause," and the agreement at issue in the *Brown & Brown* case did not contain such a clause. The court further stated that its earlier decision in *Eastman Kodak v. Carmosino*,[37] which cited *Post* in the context of a balancing of the equities analysis, "did not extend the *Post* holding to require a per se rule that involuntary termination renders all restrictive covenants unenforceable."[38]

Similarly, in *Hyde v. KLS Professional Advisors Group, LLC*, the United States Court of Appeals for the Second Circuit questioned the existence of a *per se* rule under New York law.[39] In *Hyde*, the Second Circuit reversed the grant of a preliminary injunction in favor of an employee against his former employer enjoining the employer from enforcing a restrictive covenant.[40] In remanding the case, the Second Circuit cautioned that *Post* should be limited to its holding regarding forfeiture-for-competition clauses and that *Post* does not support the *per se* unenforceability of restrictive covenants in circumstances where an employee has been terminated without cause.[41]

Conclusion

What is clear from *Post* and its progeny is that if an employer terminates the employment relationship with cause, restrictive covenants will have a greater likelihood of enforcement. What is also clear from *Post* and its progeny is that if an employer terminates the employment relationship without cause, there is a risk that restrictive covenants may not be enforced. While *Post* expressly states that it is a narrow decision, its *dicta* incorporate language broadly critical of restrictive covenants. Perhaps this is the source of the divergence as to its interpretation. Whether one agrees with the expanded or limited construction given to *Post* by New York courts, one needs to be aware of the divergent paths taken by courts in the jurisdiction. Until the New York Court of Appeals directly and firmly rejects or endorses one of the divergent views of *Post*, this uncertainty may remain.

In our research for this article, we reviewed dozens of cases involving *Post* and issues collateral to it, as well as the myth of the twins Romulus and Remus, one of whom (Romulus) is purportedly the founder of Rome. According to the myth, they were born of a mortal woman, a princess and Vestal Virgin, fathered by the god of war, Mars, abandoned by their mother after birth, suckled as infants by a wolf, fed as infants by a woodpecker, and then raised by shepherds. As adults, their innate leadership abilities manifested themselves and they fought about the choice of hill on which to build a city. Although they agreed to choose the location of the city by augury, they fought about its meaning and Romulus slew Remus. Augury[42] is the ancient Roman practice of the interpretation of omens by observation of the flight patterns of birds. According to the myth, the twins differed over the interpretation of what six or twelve vultures signified.

Certainly knowing the case law, the facts of any case and the purported proclivities of the judge to whom a case is assigned is critical to any attempt to enforce restrictive covenants when an employee is terminated without cause. But, as noted, the *Post* case has been offered as the basis for polar opposite holdings on the same issue. It seems that knowledge of augury or the flight patterns of birds may be equally as predictive of a result based on *Post* in any attempt to enforce restrictive covenants in cases involving a termination without cause.

Endnotes

1. 48 N.Y.2d 84, *rearg denied*, 48 N.Y.2d 975 (1979).
2. *Id.* at 89.
3. *Columbia Ribbon & Carbon Mfg. Co., Inc. v. A-1-A Corp.*, 42 N.Y.2d 496, 499 (1977) (citations omitted) ("Since there are powerful considerations of public policy which militate against sanctioning the loss of a man's livelihood, restrictive covenants which tend to prevent an employee from pursuing a similar vocation after termination of employment are disfavored by the law.").
4. 93 N.Y.2d 382, 388-89 (1999).
5. *See, e.g.*, *Morris v. Schroder Capital Mgmt. Int'l*, 7 N.Y. 3d 616 (2006).
6. *Id.* at 621; *see also Lucente v. Int'l Business Machines Corp.*, 310 F.3d 243, 254-55 (2d Cir. 2002).
7. *See, e.g.*, *Morris*, 7 N.Y.3d at 621 (citations omitted).
8. *Id*. at 621-22.
9. *Id.* at 622 (citations omitted).
10. *Post*, 48 N.Y.2d at 88.
11. *Id*. at 87.
12. *Id*.
13. *Id*.
14. *Id*.
15. *Id*.

16. *Id*.
17. *Post v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 411 N.Y.S.2d 603 (1st Dep't 1978).
18. *Post*, 48 N.Y.2d at 87.
19. *Id*. at 90.
20. *Id*. at 88.
21. *Id*. at 89.
22. *Id*.
23. *Id*. at 86-87 (citing *Columbia Ribbon & Carbon Manufacturing Co. v. A-1-A Corp.*, 42 N.Y.2d 496, 499 (1977); *Reed, Roberts Assoc. v. Strauman*, 40 N.Y.2d 303, 307-8 (1976)).
24. *Id*. at 89.
25. *Id*. at 86.
26. *Grassi & Co., CPAs, P.C. v. Janover Rubinroit, LLC*, 82 A.D.3d 700, 702 (2d Dep't 2011).
27. *Lenel Systems Int'l Inc. v. Smith*, 106 A.D.3d 1536, 1538-39 (4th Dep't 2013).
28. *Arakelian v. Omnicare, Inc.*, 735 F. Supp. 2d 22, 41-42 (S.D.N.Y. 2010); *SIFCO Industries, Inc. v. Advanced Plating Technologies, Inc.*, 867 F.Supp. 155, 158 (S.D.N.Y. 1994); and *Nisselson v. DeWitt Stern Group, Inc. (In re UFG Int'l, Inc.)*, 225 B.R. 51, 55-56 (S.D.N.Y. 1998).
29. *SIFCO*, 867 F. Supp. at 158.
30. *Id.*
31. *Nisselson*, 225 B.R. at 55-56.
32. *Arakelian*, 735 F.Supp.2d at 25.
33. *Id.*
34. *Id.* at 41.
35. *Morris*, 7 N.Y.3d at 621.
36. 115 A.D.3d 162, 170 (4th Dep't 2014), *rev'd on other grounds*, 2015 WL 3616181 (2015).
37. 77 A.D.3d 1434 (4th Dep't 2010).
38. *Brown & Brown*, 115 A.D.3d at 170.
39. 500 Fed.Appx. 24, at *26 (2d Cir. 2012).
40. *Id.* at *24-25.
41. *Id.* at *26.
42. Webster.com, the online dictionary, defines augury as "divination from auspices or omens."

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