

RESTRICTIVE COVENANTS: LIMITS AND ENFORCEMENT

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Restrictive covenants are essential part of the employment relationship. However, they are often given scant attention during the early, happy days of the relationship, when employers and employees are in their courtship phase. If the parties think of the covenants at all, employers may consider their restrictive covenants to be inviolable, while employees may consider the same covenants to be unenforceable. Unfortunately, at the end of the employment relationship, restrictive covenants are often a sticking point in the negotiation of the parties' separation agreement and, with increased frequency, the subject of litigation. As such, it benefits both employers and employees to consider carefully the scope of the most common restrictive covenants and the criteria for their enforcement.

I. Common Restrictive Covenants

Common restrictive covenants include non-competition provisions, restrictions against solicitation of employees and clients or customers, and confidentiality provisions. Other clauses may require employees to acknowledge an employer's ownership of documents, inventions and trade secrets. Employers may also require that new employees acknowledge that their employment relationship does not breach any restrictive covenants imposed by a prior employer.

Non-competition and non-solicitation provisions typically bind the employee both during the term of the employment relationship and for a set period thereafter. Confidentiality or non-disclosure obligations typically do not expire.

Restrictive covenants must be included in written agreements in order to be enforceable. Employers most frequently include restrictive covenants in employment agreements and/or policies presented to and signed by employees at the outset of the employment relationship. Most if not all courts consider employment to be adequate consideration for restrictive covenants although, as discussed below, they may find the provisions to be unenforceable on other grounds. Employers also may include restrictive covenants in agreements or policies that are presented to and signed by employees during the course of the employment relationship. In New York, unlike some other states, the continued employment of an at-will employee may be considered adequate consideration for those restrictions. Employers also may include restrictive covenants in deferred compensation or equity award plans. Finally, parties to asset purchase agreements may include restrictive covenants as conditions to the purchase of a business and its goodwill.

II. Enforceability of Restrictive Covenants

As a general rule, restrictive covenants entered into voluntarily will be enforced where the covenant 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.” *Reed, Roberts Associates, Inc. v. Strauman*, 40 N.Y.2d 303, 307 (1976). The determination of whether or not a restrictive covenant is enforceable is a “case-specific inquiry.” *USI Ins. Services LLC v. Miner*, 801 F. Supp.

2d 175, 188-189 (S.D.N.Y. 2011). New York courts will “blue pencil” an agreement to delete unenforceable provisions. *BDO Seidman v. Hirschberg*, 93 N.Y.2d 382, 391-93 (1999).

A. Non-Competition Provisions

Non-competition provisions are intended to prevent an employee from working for a competitor within a geographic area (which can range from a city to the world) for a set amount of time (which can range from weeks to years) after the employment relationship ends. The reasonableness of the time and geographic scope of the restriction may be determined by considering factors such as the standard restrictive covenants in the applicable industry, the rate of changes and developments in the technology of that industry, and the geographic reach of the employer.

When balancing the competing legitimate interests of the employer and employee, the courts may enforce non-competition provisions where necessary to protect an employer’s trade secrets or confidential customer information. In two recent cases, the Northern District of New York granted temporary and preliminary injunctions to an employer who sought to enforce non-competition provisions against employees who allegedly removed their employer’s confidential information before leaving the company. *Ayco Co. v. Frisch*, 795 F. Supp. 2d 193, 209 (N.D.N.Y. 2011); *Ayco Co. v. Feldman*, No. 1:10-CV-1213, 2010 WL 4286154 (N.D.N.Y. Oct. 22, 2010). The court enjoined the employees from working for any competitor for 90 days and from ever disclosing the employer’s confidential information. *Id.*

Motions for injunctions to enforce non-competition provisions may invoke the “inevitable disclosure” doctrine, under which an employer seeks an injunction on the

ground that a former employee, who had access to the employer's trade secrets and is now working for the employer's direct competitor, "could not reasonably be expected to fulfill his new job responsibilities without utilizing the trade secrets of her former employer." *EarthWeb, Inc. v. Schlack*, 71 F. Supp. 2d 299, 310 (S.D.N.Y. 1999), *aff'd*, 2000 WL 1093320 (2d Cir. May 18, 2000). In two relatively recent cases, New York federal courts granted injunctions to the employers, finding that it was inevitable that a high-ranking former employee who had access to his former employer's trade secrets would use or disclose that information in his new job working for a competitor. *Liebowitz v. Aternity, Inc.*, No. 10 CV 2289, 2010 WL 2803979, at * 20 (E.D.N.Y. July 14, 2010) (decided under Massachusetts law); *International Business Machines Corp. v. Papermaster*, No. 08–CV–9078, 2008 WL 4974508, at *9 (S.D.N.Y. Nov. 21, 2008).

In a more recent case, a New York federal court denied IBM's request for a preliminary injunction to enforce a 12-month non-compete agreement against a high level manager who went to work for a competitor. *International Business Machines Corp. v. Visentin*, No. 11 Civ. 399, 2011 WL 672025, at *1 (S.D.N.Y. Feb. 16, 2011). On the facts, the court found that the employee did not possess much confidential information, and that there was little risk of inevitable disclosure, so that the employer could not show irreparable harm. *Id.* at *7-20. The court rejected plaintiff's argument that, by signing the agreement, the employee had agreed that his non-compliance with the agreement would lead to irreparable harm. *Id.* at *7, n.4. The court also pointed out that other employees who were privy to some of same information as defendant had not been required to sign restrictive covenants, undercutting plaintiff's argument that court intervention was necessary to protect its information from disclosure. *Id.* at *5 and *10.

The court found that the non-competition agreement was not necessary to protect a legitimate interest of the employer, since the employee was not unique and did not possess trade secrets or confidential information. *Id.* at *21-22. The court noted that plaintiff's own witness testified that the real purpose of the agreement was to serve as an employee "retention device" rather than to protect trade secrets. *Id.* at *22. Finally, the court found that enforcing the agreement would impose an undue hardship on the employee, because even though he would receive 12 months of salary from the plaintiff, the position with the competitor might not be available at the end of 12 months. *Id.* at *23.

When evaluating the enforceability of a restrictive covenant, New York courts may take into consideration whether or not the employer will make any payments to the employee for the period of "garden leave," when the employee is no longer employed by the former employer but is restricted from working for a competitor. Courts are less likely to enforce restrictive covenants if the restriction would leave the employee without compensation from the former employer and without the right to earn compensation in his or her field. Employees also have a good faith argument that they are released from non-competition provisions when an employer breaches the parties' employment or severance agreement by failing to pay severance payments due. *See, e.g., Cornell v. T.V. Dev. Corp.*, 17 N.Y.2d 69, 75, 268 N.Y.S.2d 29, 34 (1996); *DeCapua v. Dine-A-Mate, Inc.*, 292 A.D.2d 489, 744 N.Y.S. 2d 417 (2d Dep't 2002).

The circumstances surrounding the employee's termination also may affect the enforceability of restrictive covenants. Under the "employee choice doctrine," restrictive covenants are held to be enforceable where employees who voluntarily terminate their

employment may choose to either comply and receive compensation (such as severance, deferred compensation or equity awards) or engage in the restricted activity and forego the compensation or award. See, e.g., *Morris v. Schroder Capital Mgmt. Int'l*, 7 N.Y.3d 616 (2006). When an employee is involuntarily terminated without cause, the employee choice doctrine does not apply and the Court must determine whether forfeiture is reasonable. *Morris*, 7 N.Y.3d at 701; *Post v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 48 N.Y.2d 84, 421 N.Y.S.2d 847, 848 (1979) (forfeiture of pension benefits earned by employee who is involuntarily discharged is “unreasonable as a matter of law”); see also *Lucente v. International Business Machines Corp.*, 310 F.3d 243, 254-55 (2d Cir. 2002). Some federal courts have held that when an employee is involuntarily terminated without cause, non-competition provisions are *per se* not enforceable under New York law. *Arakelian v. Omnicare, Inc.*, 735 F. Supp. 2d 22, 41-42 (S.D.N.Y. 2010); *SIFCO Indus., Inc. v. Advanced Plating Technologies, Inc.*, 867 F. Supp. 155, 158 (S.D.N.Y. 1994); but see *Hyde v. KLS Professional Advisors Group, LLC*, No. 12-1484-CV, 2012 WL 4840714, at *2 (2d Cir. Oct. 12, 2012) (dicta).

In a question certified to the New York Court of Appeals by the Second Circuit, the Court held that the constructive discharge test is the appropriate legal standard to apply when determining whether an employee voluntarily or involuntarily left his employment for purposes of the employee choice doctrine. *Morris*, 7 N.Y.3d at 618.

B. Non-Solicitation Provisions

Solicitation may consist of initiating contact with former clients and colleagues, taking affirmative steps to communicate directly with former clients and colleagues (such as through targeted mailings), and even touting one's new business venture when contacted by a former client. *Miner*, 801 F. Supp. 2d at 191-92. Where a contract prohibits both "direct" and "indirect" solicitation, an employee may not act behind the scenes to assist his or her new employer to pursue his or her former clients, customers and/or colleagues. *Marsh USA Inc. v. Karasaki*, No. 08 Civ. 4195, 2008 WL 4778239, at *20 (S.D.N.Y. Oct. 31, 2008).

In *Miner*, defendant sold his insurance business and its goodwill to plaintiff. Within days, defendant joined another insurance company and sent an email to "everybody . . . in his contact list," including plaintiff's clients, stating that he had terminated his relationship with plaintiff and joined the new employer, which was "firmly committed to providing you with exceptional service." *Id.* at 192. The court held that this e-mail constituted solicitation as a matter of law. *Id.* at 193. The court rejected defendant's argument that the e-mail was not "targeted" because it also included friends and family and that it was just "bragging." *Id.* at 193, n. 19. *Compare Bessemer Trust Co. v. Branin*, 16 N.Y.3d 549, 559-560 (2011) (under an implied covenant not to solicit, one who has sold the goodwill of his business may not "contact his former clients directly," but he may (i) answer factual questions "in response to inquiries made on a former client's own initiative," (ii) assist his new employer in the "active development . . . [of] a plan" to respond to that client's inquiries, and (iii) attend a meeting with the former client in a "largely passive role").

The *Miner* court suggested that “it may have been permissible for defendant to inform his former clients with whom he had a professional relationship that he was moving to a new company,” but found that defendant's e-mail did more than that by touting the merits of his new employer. 801 F. Supp. 2d at 193, n. 20; see also *FTI Consulting, Inc. v. Graves*, No 05 Civ. 6719, 2007 WL 2192200, at *7 (S.D.N.Y. July 31, 2007) (defendant was permitted to simply inform clients of his departure from plaintiff employer); compare *Ecolab, Inc. v. K.P. Laundry Machinery, Inc.*, 656 F. Supp. 894, 896-97 (S.D.N.Y. 1987) (“[a]lthough ostensibly sent as goodbye notes, it is clear that the letters [sent by defendants to their former customers] were actually intended as a first step in the solicitation” of those customers on behalf of the new employer).

The courts have limited the scope of the non-solicitation provisions to customer relationships created or maintained by the employer or at the employer's expense. *BDO Seidman v. Hirschberg*, 93 N.Y.2d at 391-93; see also *IDG USA, LLC v. Schupp*, No. 10-CV-768, 2010 WL 3260046, at *1, *6, *7 (W.D.N.Y. Aug. 18, 2010), *aff'd in part, rev'd in part*, 416 F. App'x 86 (2d Cir. Mar. 25, 2011) (granting preliminary injunction where clients had been assigned to employee by the employer and the client relationships had been developed at the employer's expense). In contrast, an employer does not have a legitimate interest in preventing a former employee from providing services to “personal clients . . . who came to the firm solely to avail themselves of his services an only as a result of his own independent recruitment efforts.” *BDO Seidman*, 93 N.Y.2d at 393; see also *Frank Crystal & Co. v. Dillmann*, 84 A.D.3d 704, 925 N.Y.S.2d 430 (1st Dep't 2011); *Weiser LLP v. Coopersmith*, 74 A.D.3d 465, 902 N.Y.S.2d 74 (1st Dep't 2010) (clients developed from independent sources including the

employee's family); *Guardian Life Ins. Co. v. Brill*, No. 113709/10, 2011 WL 1826852 (Sup. Ct. N.Y. Cnty. Apr. 28, 2011).

As with non-competition provisions, non-solicitation provisions may be held unenforceable if they are unreasonable in time and geographic scope. In *Miner*, the court found reasonable a non-solicitation clause that would prohibit defendant for 24 months from accepting business from former clients who voluntarily and without any solicitation choose to continue to do business with defendant. The court cited other cases holding that similar 24 month restrictions on solicitation of former clients in the insurance industry were reasonable. 801 F. Supp. 2d at 190-91. In a recent case involving employees of a fitness center, the court found that the covenants against competition and client solicitation were overbroad because they ran for 10 years and contained no geographic limitations. *Pure Power Boot Camp, Inc. v. Warrior Fitness Boot Camp, LLC*, 813 F. Supp. 2d 489, 507-08 (S.D.N.Y. 2011).

In balancing the competing legitimate interests of the employer and employee, the courts have recognized (i) the general enforceability of non-solicitation covenants in employment agreements that "are necessary to prevent disclosure of trade secrets or confidential information or where an employee's services are unique or extraordinary," (ii) an employer's interest in protecting clients procured through the use of a company's name and resources, and (iii) the "duty to refrain from soliciting former customers, which arises upon the sale of the 'good will' of an established business." *Miner*, 801 F. Supp. 2d at 190-91.

C. Confidentiality and Non-Disclosure Provisions

Confidentiality agreements and non-disclosure provisions often define what is deemed confidential by the employer, but these documents do not end the discussion. The courts retain the discretion to determine what is confidential and/or protected as a trade secret. See e.g., *Miner*, 801 F. Supp. 2d at 194-196 (denying defendant's motion for summary judgment on the issue of whether the client coverage, contact, and policy information that he e-mailed from his work to his personal account constituted confidential information or was protected as a trade secret); *Schanfield v. Sojitz Corp.*, 663 F. Supp. 2d 305, 345 (S.D.N.Y. 2009) (granting summary judgment on liability, finding that former employee breached non-disclosure provision in employment contract by e-mailing his employer's documents containing "sensitive risk analysis" to third parties and retaining them after his termination).

Courts have held confidential information and trade secrets to include the employer's business plan, operations manual, pricing policy, profit structure and, in some circumstances, customer lists. *Pure Power Boot Camp, Inc. v. Warrior Fitness Boot Camp, LLC*, 813 F. Supp. 2d at 518-19; *IDG USA, LLC*, 2010 WL 3260046. Customer lists may not be considered confidential if they are available from public sources, or from sources other than the employer.

Restrictions on disclosure of confidential information and trade secrets are generally not limited in time or geographic scope, and may last forever. *Ayco Co. v. Frisch*, 795 F. Supp. 2d at 209.

In addition to the contractual claims, employers may also seek to assert common law claims, such as unfair competition, misappropriation of trade secrets, breach of

fiduciary duty and breach of loyalty, against employees for alleged improper use or disclosure of the employer's confidential information or trade secrets. See, e.g., *IDG USA, LLC*, 2010 WL 3260046 at *15-16; *Henbest & Morissey Inc v. W.H. Ins. Agency, Inc.*, 259 A.D.2d 829, 686 N.Y.S.2d 207 (3d Dep't 1999). Employers should be aware that pursuing such claims may require them to disclose the allegedly misappropriated trade secret during discovery. *MSCI Inc. v. Jacob*, 945 N.Y.S.2d 863, 865-66 (Sup. Ct. 2012) (requiring plaintiff to disclose source code allegedly misappropriated by defendants).

III. Damages

As discussed above, employers may be entitled to injunctive relief for a former employee's breach of restrictive covenants. See, e.g., *Ayco Co. v. Frisch*, 795 F. Supp. 2d at 209; *International Business Machines Corp. v. Papermaster*, 2008 WL 4974508, at *9; compare *Richard Manno & Co. v. Manno*, 946 N.Y.S.2d 69 (Sup. Ct. 2012).

Employers may also seek monetary damages. The "measure of damages for a violation of a restrictive covenant is the loss sustained by reason of the breach, including the 'net profits of which the plaintiff was deprived' by the defendant's acts." *Pure Power Boot Camp*, 813 F. Supp. 2d at 519. But "[l]ost profits may be recovered only if: (1) lost profits were 'fairly within the contemplation of the parties to the contract at the time it was made'; (2) lost profits were caused by the defendant's breach; and (3) damages are 'capable of proof with reasonable certainty.'" *Id.* In *Pure Power Boot Camp*, the court found that plaintiff could satisfy none of these requirements because: (1) the employment agreements failed to mention lost profits; (2) plaintiff failed to prove that but for defendant's theft and use of its confidential information, it would have

earned these profits; and (3) plaintiff's calculations were inherently speculative and its expert's methodology was flawed. *Id.* at 520. Therefore, the court declined to award plaintiff any lost profits damages on its claim for breach of the non-disclosure agreement.

Employers may also seek to bring claims, such as tortious interference with contract or aiding and abetting breach of fiduciary duty, against the new employer. See *Barbagallo v. Marcum LLP*, 820 F. Supp. 2d 429, 444-45 (E.D.N.Y. 2011).

Conclusion

The drafting of restrictive covenants requires a careful review of the facts regarding the legitimate business needs of the employer, the role of the employee and the common practices in the applicable industry, as well as the law in the jurisdictions applicable to the employer and employee. Courts are more likely to enforce restrictive covenants that are tailored to balance both the legitimate business interests of the employer and the employee's legitimate need to earn a livelihood in his or her chosen profession.

S.B.G.

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