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Enforcing Restrictive Covenants in Times Of **Layoffs**

Can employers have their cake and eat it too?

IN THESE challenging economic times, layoffs and corporate reorganizations are becoming more commonplace. Employers in the midst of such job actions are also being forced to address an array of employment laws and business issues relating to these matters. Central among their concerns is the ability to continue their business operations with minimal disruption and to protect their business interests in the face of large-scale terminations.

BY JONATHAN STOLER

Indeed, how to maintain protection over confidential business information and to ensure a company's continued competitive edge following layoff situations is the question of the day. One answer is through the enforcement of non-competition or other types of restrictive covenants that may have been in place prior to a layoff or similar job action. As the following suggests, however, an employer's ability to enforce restrictive covenants against employees subject to layoffs may be more difficult than it appears.

Within the employment context, a restrictive covenant is typically set forth in an agreement signed by the employee and the employer, in which the employee agrees not to pursue a similar profession or trade, or solicit clients or other business associates, in competition with the employer. It is well established in New York, as well as other jurisdictions, that courts will enforce restrictive covenants if they are reasonably limited in time, geographic scope and duration to the extent necessary to protect the employer from unfair competition resulting in the use or disclosure of their business interests by the former employee.[1] The intention of these agreements is to prevent employees from competing or soliciting against their former employers and to prevent the use of trade secrets and other protectable business interests.

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A quandary arises when an employee is involuntarily discharged by his employer. Contrary to voluntarily leaving under his own volition (or at the end of an employment contract), employees who are selected for a reduction in force or involuntarily laid off may have suitable grounds to challenge an otherwise valid restrictive covenant because there no longer exists the mutuality of obligation on which the covenant rests.[2] This possibility is especially troublesome in New York, where a majority of courts have consistently found agreements under these conditions to be unenforceable, exposing employers to the very competitive activities they were seeking to prevent.[3]

New York Courts

In New York, the widely accepted view is that an employee's otherwise enforceable restrictive covenant not to compete will be deemed unenforceable if the employee has been involuntarily terminated by the employer without cause.[4] Without any legitimate justification for termination, New York courts have held that employers should not be able to both deny an employee earned compensation and benefits as well as prevent him from engaging in his chosen livelihood.[5]

Post v. Merrill Lynch, Pierce, Fenner & Smith Inc. clearly marked the distinction between voluntary and involuntary termination of employment and whether or not restrictive covenants may continue to be enforced.[6] In *Post*, a group of employees who were involuntarily terminated from Merrill Lynch without cause, brought an action against their former employer questioning the enforceability of a non-competition clause in their pension plans.[7] The agreement at issue did not attempt to bar employees from engaging in future employment but presented them with a choice to either refrain from competition with their employer or forfeit their pension plan rights.[8] This was the first instance where a New York court was asked to distinguish between voluntary and involuntary terminations without cause as applied to the enforceability of restrictive covenants.[9]

In holding that the agreement was unenforceable, the New York Court of Appeals in *Post* relied in large part on the strong public policy in favor of permitting individuals to work—where and for whom they please—rather than forfeit their pension rights.[10] Of greater significance, however, was the Court's emphasis on the importance of the individual's freedom to contract and to willingly enter into a bargained for agreement.[11] The Court reasoned that because Merrill Lynch involuntarily discharged the employees at issue without cause, the mutuality of obligation on which their contracts rested no longer existed.[12]

Since the *Post* decision, New York courts have consistently applied this reasoning by refusing to enforce a restrictive covenant not to compete against an employee who is involuntarily discharged without cause.[13] This is not to say that employees who are subject to non-compete agreements and who are subsequently involuntarily terminated may never be held to such restrictive covenants. Indeed, when such an employee is terminated for "cause," employers may have a basis to enforce restrictive covenants if they are deemed reasonable.

The main question that lingers in such circumstances is what constitutes "cause" in a termination context. Employers who terminate an employee based on misconduct, such as a policy violation or neglect of job duties, will likely satisfy the "cause" definition, and the covenant will be enforced if it is deemed to be reasonable.[14] Moreover, in an economic climate where large-scale layoffs are required, some employers have attempted to extend the "cause" definition to include poor financial conditions.[15] However, as set forth below, such attempts have been largely unsuccessful.

In *UFG International Inc.*, the employer at issue was experiencing financial difficulties that required it to terminate a group of employees who were subject to restrictive covenants.[16] Although these employees were clearly being terminated involuntarily, the employer, who was in the midst of bankruptcy proceedings in the Southern District of New York, attempted to enforce their restrictive covenants by arguing that their terminations were for "cause," given the company's tenuous financial position.[17]

The bankruptcy court disagreed with the employer and ruled that the company's financial difficulties did not constitute cause for termination.[18] Thus, the court refused to enforce the restrictive covenants against the laid-off group of employees.[19] As many other New York courts have held, the *UFG* court reasoned that it would be extremely unfair for an employer to be able to hobble the employee by terminating him without cause and then enforcing a restriction that diminishes his ability to find comparable employment.[20]

Similar reasoning was used in *SIFCO Industries Inc. v. Advanced Plating Technologies Inc.* to hold that

a company's financial difficulties did not constitute termination for "cause" and would not warrant the enforcement of a restrictive covenant.[21] In *SIFCO*, a successor corporation decided to immediately shut down operations at one of the plants formerly operated by the predecessor.[22] All of the plant's employees were discharged and instead of being offered comparable employment, the successor offered consultancy positions at a much lower rate.[23] The Southern District court found that each employee was terminated involuntarily and without cause.[24] Since the successor corporation made no effort to offer these former employees any continued and comparable employment, the court held the restrictive covenant at issue, in this case a non-competition provision, was unenforceable since the mutuality of obligation ceased to exist.[25]

Other States

While the reason for an employee's termination may be a determinative factor that is considered by New York courts, the prevailing viewpoint in other jurisdictions is to administer a balancing of the equities test to determine whether a covenant should be enforced.[26] For example, both New Jersey and Connecticut apply this type of test and consider the nature of an employee's termination as just one of the many factors to be reviewed in determining the enforceability of restrictive covenants.[27]

In New Jersey, the court in *All Quality Care Inc. v. Karim* reasoned that an employee's post-employment restrictive covenant would be enforceable only if it was reasonable under all the circumstances of the particular case.[28] Significantly, the state Superior Court found the plaintiff's involuntary termination did not create a bright-line rule against enforceability, but was weighed in determining the enforceability of the contract along with considerations of reasonableness.[29] Although the covenant was not ultimately enforced, the court highlighted that each situation is fact-sensitive and a restrictive covenant's enforceability should be considered on a case-by-case inquiry.[30]

Connecticut courts have likewise adopted a balancing test and have specifically held that the reason for terminating an employee is not a deciding factor in such test.[31] In *Robert S. Weiss and Associates Inc. v. Wiederlight*, the state Supreme Court held that the reasonableness of a non-competition agreement did not turn on whether the employee subject to the covenant left his position voluntarily or involuntarily.[32] Indeed, the Court noted that, as long as the restrictive covenant was reasonable in light of the typical considerations of time, manner, geographic area and undue hardship, courts routinely upheld these covenants even in cases of involuntary termination.[33]

While certain jurisdictions consider the manner of termination as one of several factors in determining a restrictive covenant's reasonableness, others do not consider the reason for termination at all.[34] In *The Twenty Four Collection Inc. v. Keller*, a leading Florida case, the employee at issue was subject to a non-compete agreement and was involuntarily terminated by her employer.[35] The employee was thereafter hired by a direct competitor, and her former employer moved to enforce the non-compete agreement.[36]

The lower court reviewing the non-compete held that the individual was not bound by the terms of the agreement. The court applied a balancing test and determined that the employee's desire to work outweighed the allegedly harsh result of enforcing the contract against her.[37] The lower court's decision was overruled on appeal.[38] Specifically, the state appellate court stated that the lower court should only look to the reasonableness of the non-compete agreement to determine enforceability (rather than looking at the method of termination.)[39] Since the reasonableness of the agreement (a two-year, three-county limitation provision) was not yet determined, the issue was to be considered on remand.

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New Agreements

Regardless of jurisdiction, it is clear that any action to enforce restrictive covenants against involuntarily terminated employees—and particularly those terminated pursuant to a reduction in force—will be strictly scrutinized, if not denied outright by reviewing courts. Employers who are contemplating layoffs and concerned about the competitive activities of affected employees may nevertheless avoid these pitfalls by asking such employees to enter into new restrictive covenants at the time of layoff in exchange for a cash payment or other post-employment benefit.

Indeed, many employers implementing reductions in force already offer affected employees severance benefits in exchange for a release of claims, typically set forth in a separation agreement. Such employers may simply add a restrictive covenant to that same separation agreement and have the severance benefits satisfy the consideration requirement. Under this scenario, the "mutuality of obligation" element is satisfied by the post-employment benefit (in this case, severance) rather than continued employment. Not surprisingly, many employers find that the benefit of protecting their valuable business interests through post-employment restrictive covenants often outweighs the costs of severance packages to former employees. This alternative approach will also fortify a company's competitive edge and help secure its standing in today's difficult economic environment.

1. See *American Broad. Cos. v. Wolf*, 52 NY2d 394, 403 (1981); *Post v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 48 NY2d 84, 87 (1979); *Columbia Ribbon & Carbon Mfg. Co. v. A-1-A Corp.*, 42 NY2d 496, 499 (1977); *Reed, Roberts Assocs. v. Strauman*, 40 NY2d 303, 307-08 (1976).

2. See *Post*, 48 NY2d at 89; *In re UFG Int'l*, 225 B.R. 51, 56 (Bankr. SDNY 1998). Whether or not an employee is voluntarily or involuntarily discharged does not affect the protections afforded to trade secrets. This obligation to protect the future disclosure and use of trade secrets remains intact even after an employee's relationship with a company ends. See *Byrne v. Barrett*, 268 NY 199, 206 (1935) ("the duty of an…employee not to use confidential knowledge acquired in his employment…is implicit in the relation…[and] [i]t exists as well after the employment is terminated as during its continuance. It is an absolute and not a relative duty.") (citations omitted); see also *Business Networks of New York Inc. v. Complete Network Solutions Inc.*, 1999 WL 126088, at * 5 (N.Y. Sup. Ct. Feb. 19, 1999) (recognizing that an employee's duty to not divulge the confidential information of the employer survives the termination of the employment relationship).

3. See *UFG*, 225 B.R. at 56; *SIFCO Indus. Inc. v. Advanced Plating Tech[s] Inc.*, 867 F.Supp. 155, 159 (SDNY 1994); *Post*, 48 NY2d at 88; *Cornell v. T.V. Dev. Corp.*, 17 NY2d 69, 75 (1966).

4. Although there is a competing school of thought which proposes that there is not such a bright-line rule in New York, New York courts have historically declined to enforce an otherwise reasonable restrictive covenant against employees whose involuntary terminations were without cause. See *UFG*, 225 B.R. at 55; *Post*, 48 NY2d at 88; *Cornell*, 17 NY2d at 75; see also: *Edward Brown Inc. v. Astor Supply Co.*, 4 AD2d 177, 179 (1957) (refusing to enforce restrictive covenant under conditions amounting to discharge without cause).

5. See *Cray v. Nationwide Mut. Ins. Co.*, 136 F.Supp.2d 171, 179 (WDNY 2001).

6. See 48 NY2d at 88.

7. See id. at 87.

8. See id. at 88.

9. See id.

10. See id.

11. See id. at 89.

12. See id.

13. See *UFG*, 225 B.R. at 56; *SIFCO*, 867 F.Supp. at 159.

14. See *Gismondi, Paglia, Sherling, M.D., PC v. Franco*, 104 F.Supp.2d 223, 233 (SDNY 2000); see also: *Cray*, 136 F.Supp.2d 171, 179 (WDNY 2001) (enforcing a restrictive covenant when employee's termination was for good cause); *UFG*, 225 B.R. at 56 (ruling that termination for cause is required under New York law if an employer desires to enforce a restrictive covenant following involuntary termination of an employee); *MTV Networks v. Fox Kids Worldwide Inc.*, No. 605580/97, 1998 N.Y. Misc. LEXIS 701, *23 (New York Co. May 13, 1998) (holding that defendant was properly terminated for cause, and employer was therefore entitled to injunctive relief under non-compete provision of employment contract).

15. See *UFG*, 225 B.R. at 56; *SIFCO*, 867 F.Supp. at 159.

16. See 225 B.R. at 53.

17. See id. at 55.

18. See id. at 56.

19. See id.

20. See id.

21. See 867 F.Supp. at 159.

22. See id. at 155.

23. See id. at 156.

24.. Id. at 158.

25. See id. at 158-59.

26. See *Post*, 48 NY2d at 89; *All Quality Care Inc. v. Karim*, 2005 WL 3526089 (N.J. Super. Ct. App. Div. 2005) (unpublished); *Platinum Mgmt. v. Dahms*, 285 N.J. Super. 274, 293-94 (Law. Div. 1995); *Robert S. Weiss and Assocs. Inc. v. Wiederlight*, 208 Conn. 525, 532 (1988).

27. See *All Quality Care*, 2005 WL 3526089 at *3; *Platinum Mgmt.*, 285 N.J. Super. at 293-94; *Robert S. Weiss & Assocs. Inc.*, 208 Conn. 525, 532 (1988).

28. See 2005 WL 3526089 at *3; see *Hogan v. Brunswig Corp.*, 153 N.J.Super. 37, 41 (App. Div. 1977).

29. See *All Quality Care*, 2005 WL 3526089 at *3.

30. See id. at *3; see also: *Platinum Mgmt.*, 285 N.J. Super at 294 (reiterating that a restrictive covenant's enforceability must be determined in light of the facts of each case).

31. See *Robert S. Weiss*, 208 Conn. at 532; see also: *Torrington Creamery Inc. v. Davenport*, supra, 126 Conn. 515, 520 (1940) (holding that the employer was under no obligation to offer to keep employee as a condition to enforcing the restrictive covenant).

32. See *Robert S. Weiss*, 208 Conn. at 532; *Torrington Creamery*, 126 Conn. at 520.

33. See *Robert S. Weiss*, 208 Conn. at 532; see also: *Kroeger v. Stop & Shop Cos.*, 13 Mass.App. 310, 320, appeal denied, 386 Mass. 1102 (1982) (ruling that the termination of employment at the initiative of the employer does not itself render restrictive covenant unenforceable).

34. See *The Twenty Four Collection Inc. v. Keller*, 389 So. 2d 1062, 1063 (Fla. Dist. Ct. App.), review denied, 419 So. 2d 1048 (Fla. 1980).

35. See id. at 1062.

36. See id.

37. See id. at 1063.

38. Id. at 1064.

39. Id. at 1063.