Non-Competes Under New York Law - What Every Small Business and Executive Needs to Know

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Continuing Legal Education

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Welcome!

- Goals for Today's Lecture:
  - To gain a better understanding of the role that non-compete and non-solicit agreements play in the workplace under New York law
  - If you have non-compete agreements, what your expectations should be about those agreements
    - (**Spoiler Alert**: Yes, there are many instances where they will be upheld by a NY Court)
  - How you can structure non-competes in a better way to make it more likely to be enforceable

Do Non-Competes Really Matter in the Business World?

- What do you tell an employer whose client base is being threatened?
- Is it any different if his employee roster is being poached?
  - What if you ***know*** that a disloyal employee is diverting business, but you can't really prove it?
- What do you tell an employee who has just been let go, and his former employer threatens to sue him if he takes a job with a competitor?
  - What if that employee has a family, and needs that job just to pay his bills?

Competing Policies/Schools of Thought Regarding Non-Competes

The California/Massachusetts Rule

- HBR Article
- Studies

The New York Rule

- Balancing Test –
  - "[N]o restrictions should fetter an employee's right to apply to his own best advantage the skills and knowledge acquired by the overall experience of his previous employment. This includes those techniques which are but 'skillful variations of general processes known to the particular trade.'

On the other hand ...

"[T]he courts must also recognize the legitimate interest an employer has in safeguarding that which has made his business successful and to protect himself against deliberate surreptitious commercial piracy."

- Reasonableness (Why it's often a question of fact) (It is well established under New York law that restrictive covenants in employment agreements are "enforceable only to the extent that they satisfy the overriding requirement of reasonableness." *Reed, Roberts Assocs., Inc. v. Strauman*, 40 N.Y.2d 303, 386 N.Y.S.2d 677, 353 N.E.2d 590 (1976).)

Forum Selection Clauses Are Critical

- New York's 4-Part Test:
  1) Reasonably communicated to the Resisting Party?
  2) Mandatory or Permissive?
  3) Are the claims (and parties) subject to the Forum Selection Clause?
  4) Has Party Resisting Forum Selection Clause rebutted presumption by showing that enforcement would be unfair/unjust?
- If no Forum Selection Clause, "Forum Non-Conveniens" Applies
  - 5-Part Test
  - Practical Considerations: Why should a New York judge effectively volunteer to be burdened with a case that really belongs somewhere else?

Non-Compete vs. Non-Solicit

Sample Non-Compete

"In exchange for initial and/or continued employment, at the Termination Date, **EMPLOYEE** shall not in any way Compete, as defined below, with [Employer] for a period of one year.

"The term "Compete" includes, but is not limited to:

i) providing services directly, indirectly or on behalf of a third party to any person or entity in the Geographic Area that are within the scope of services provided by EMPLOYER ("competing services");

ii) providing services directly, indirectly or on behalf of a third party to [Employer]'s Customers located anywhere including outside of the Geographic Area;

iii) soliciting directly, indirectly or on behalf of a third party any customer for [Employer]'s services in the Geographic Area, whether or not [Employer] is under contract with them or has a business relationship with them, for any reason whatsoever including but not limited to soliciting contact information, business or referrals;

iv) advertising and promoting competing services or products in any existing or future advertising medium, including, but not limited to, e-mail, social networking media, radio, television, newspaper, periodical, trade magazine, trade show, convention, flyer and direct mail which is aired, received or takes place, as applicable, in the Geographic Area."

Non-Compete vs. Non-Solicit

Sample Non-Solicit

Non-Competition; Non-Solicitation. Inducer agrees that for a period (the "***Restricted Period***"*),* commencing from the Effective Time until the six (6) year anniversary of the date hereof, Inducer will not directly or indirectly, whether as an owner, partner, stockholder, joint venturer, corporate officer, director, employee, consultant, principal, trustee, lender or licensor, or in any other similar capacity whatsoever, of or for any person, firm, partnership, company or corporation (other than for Acquiror or any of its affiliates): (a) engage, own, manage, operate, sell, finance, control or participate in the engagement, ownership, management, operation, sales, finance or control of, or be connected in any manner with, any business that competes with the Business; (b) approach or solicit in connection with a competing business purpose, or divert, interfere with or take away, or attempt to approach or solicit in connection with a competing business purpose, or divert, interfere or take away, the business or patronage of any of the clients, customers or suppliers of the Target or Acquiror which are presently existing or identified as prospective clients, customers or suppliers; or (c) recruit or solicit any person who is or was employed by Target, Acquiror or any of their respective affiliates, or induce or attempt to induce or take any action which is intended to induce any employee of Target, Acquiror or any of their respective affiliates to terminate his or her employment with, or otherwise cease his or her relationship with, Acquiror or any of its affiliates, or interfere in any manner with the contractual or employment relationship between Acquiror or any of its affiliates and any employee of Acquiror or any of its affiliates; provided however, the restriction in Paragraph I(c) shall terminate upon (i) termination of the employee's employment by Acquirer or its affiliate, as applicable; or (ii) sale of Target, whether by sale of stock, sale of assets, merger, or otherwise. In addition, notwithstanding any restriction in this Paragraph 1, Inducer is permitted to own, as a passive investor, up to a 1% interest in any publicly-traded entity. The restrictions set forth in this Paragraph 1 shall be effective within all cities, counties, states, provinces or other similar designated regions of the Geographic Area.

The Crucial Difference Between a Non-Compete & a Non-Solicit

"[W]here an employer proffers protecting customer goodwill as the legitimate interest it seeks to protect with a restrictive covenant, the covenant must actually protect that interest.

"A broad non-compete that baldly prevents competition will not be enforced, particularly where the employer is already protected by a non-solicitation agreement. This is the standard set forth by the New York Court of Appeals in *BDO Seidman v. Hirshberg*, 93 N.Y.2d 382 (1999). There, the court explained that a restraint will only be considered reasonable if it is "no greater than is required for the protection of the legitimate interest of the employer…." Id. at 388-89 (emphasis in original)." *Verarmark Technologies v. Bouk.*

The Factors NY's Courts Consider to Decide if a Non-Compete/Non-Solicit is Enforceable

- ✓ Reasonable Geographic Scope
- ✓ Reasonable Duration
- ✓ Legitimate Interest
- ✓ Not Injurious to the Public

Geographic Scope/Duration

- How some NY Courts Have Held - *Good Energy, L.P. v. Kosachuk,* 49 A.D.3d 331, 332, 853 N.Y.S.2d 75 (1st Dep't 2008) (holding unenforceable a non-compete covenant that covered the entire United States where employer only operated in eight states);
- Where the company actually operated in the entire continental U.S., some courts have upheld that territorial restriction. See, e.g., *Payment Alliance Intern., Inc. v. Ferreira*, 530 F.Supp.2d 477 (S.D.N.Y. 2007)

- Duration and scope inextricably tied to legitimate interest – some cases invalidated 6 mos. - 1 year; others upheld 5 years *Gelder Medical Group v. Webber*, 41 N.Y.2d 680, 363 N.E.2d 573, 394 N.Y.S.2d 867 (1977)

Not Injurious to the Public

- Doctors -
  - Two year covenant restricting cardiologist from practicing at hospitals within city area was harmful to general public and its enforcement unnecessary to protect previous employer's interests, and thus was unenforceable insofar as it prohibited cardiologist from attending to his patients referred to city area hospitals from his practice outside city. (Muller v. N.Y. Heart Center Cardiovascular Specialists P.C., 656 N.Y.S.2d 464)
  - While restrictive covenant tending to prevent person from pursuing his or her vocation after termination of employment relationship are disfavored by law, they generally will be enforced against medical and dental professionals if they are reasonably limited temporally and geographically and, without being harmful to public or unduly burdensome, serve acceptable purpose of protecting former employer or associate from unfair competition. Rifkinson-Mann v. Kasoff, 641 N.Y.S.2d 102

- Lawyers – "[R]estrictions on the practice of law, which include "financial disincentives" against competition as well as outright prohibitions, are objectionable primarily because they interfere with the client's choice of counsel: a clause that penalizes a competing attorney by requiring forfeiture of income could "functionally and realistically discourage" a withdrawing partner from serving clients who might wish to be represented by that lawyer. *Cohen v. Lord, Day & Lord*, 75 N.Y.2d 95, 550 N.E.2d 410, 551 N.Y.S. 2d 157 (1989)

Legitimate Interest

- Biggest Battleground
- "An employer may assert only four types of 'legitimate interests'," *Silipos, Inc. v. D. Bickel,* No. 05–cv–4356 (RCC), 2006 WL 2265055, at *3 (S.D.N.Y.2006):
  - (1) protection of trade secrets;
  - (2) protection of confidential customer information;
  - (3) protection of an employer's client base; and,
  - (4) protection against irreparable harm where an employee's services are unique or extraordinary," *id.* (citing *BDO,* 712 N.E.2d at 1224–25).

The 6-Part Test for Determining What is (and Isn't) a "Trade Secret"

(l) the extent to which the information is known outside of [the] business;

(2) the extent to which it is known by employees and others involved in [the] business;

(3) the extent of measures taken by [the business] to guard the secrecy of the information;

(4) the value of the information to [the business] and [its] competitors; (5) the amount of effort or money expended by [the business] in developing the information;

(6) the ease or difficulty with which the information could be properly acquired or duplicated by others." Restatement of Torts § 757, comment b (1939).

"The most important consideration remains whether the information was secret." *482 *Lehman v. Dow Jones & Co., Inc.*, 783 F.2d 285, 298 (2d Cir.1986).

Why New York's Courts Are Unlikely to Enforce a Non-Compete Unless It's a "Key" or "Unique" Employee

- "An employee's mere 'knowledge of the intricacies of [a former employer's] business operation' is not a protectable interest sufficient to justify enjoining the employee 'from utilizing his knowledge and talents in this area.' *Reed, Roberts Assocs., Inc. v. Strauman*, 40 N.Y.2d 303 (1976).
- ("[W]here an employee's services are not extraordinary or unique, restrictive covenants are enforceable "only to the extent necessary to prevent the employee's use or disclosure of his former employer's trade secrets, processes or formulae, or his solicitation of, or disclosure of any information concerning the other's customers." *Purchasing Associates, Inc. v. Weitz*, 13 N.Y.2d 267, 272, 246 N.Y.S.2d 600, 196 N.E.2d 245 (1963)).

When is an Employee “Unique?”

- The standard for deeming an employee "unique," and therefore subject to being enjoined from working for a competitor in the same industry is "high," as the employer will be required to show that the employee's replacement is essentially "impossible." *International Creative Management, Inc. v. Abate*, No. 07 Civ. 1979, 2007 WL 950092 at *6 (S.D.N.Y. Mar. 28, 2007).
- New York’s courts have found that an employee was, in fact, “unique” where the following criteria were met:

  (1)The employee worked in a highly specialized field with a small potential pool of clients;

  (2)The employee’s success depended on his ability to cultivate a relationship with his clients; and,

  (3)The plaintiff, and former employer, was able to demonstrate with competent evidence – not just their say-so – that they had expended a lot of time, money and effort to help cultivate those special relationships.

When the Employment Contract Ends

- Doesn't necessarily mean that non-compete is also over

  Under New York law, "[W]hen an agreement expires by its terms, if, without more, the parties continue to perform as theretofore, an implication arises that they have mutually assented to a new contract containing the same provisions as the old." *Martin v. Campanaro*, 156 F2d 127 (2nd Cir. 1946) cert denied 329 US 759 (1946). See also, *North Am. Hyperbaric Ctr. v. City of New York*, 198 AD2d 148 (1st Dept 1993).

- Presumption is Rebuttable –
  - ("[T]he presumption is one of fact and may be rebutted." *Borne Chemical Co., Inc. v. Dictrow*, 85 A.D.2d 646, 648 (2nd Dept 1981)).

Protection of Client Base

- An employer retains "a legitimate interest in preventing former employees from exploiting * * * the goodwill of a client or customer, which had been created and maintained at the employer's expense, to the employer's competitive detriment"
  (*BDO Seidman v. Hirshberg, supra* at 392, 690 N.Y.S.2d 854, 712 N.E.2d 1220).
- *Leo Silfen, Inc., v. Cream,* 29 N.Y.2d 387, 392–93, 328 N.Y.S.2d 423, 278 N.E.2d 636 (1972) ("where the customers are not known in the trade or are discoverable only by extraordinary efforts courts have not hesitated to protect customer lists and files as trade secrets. This is especially so where the customers' patronage had been secured by years of effort and advertising effected by the expenditure of substantial time and money."); *see also* *Eastern Bus. Sys., Inc. v. Specialty Bus. Solutions,* 292 A.D.2d 336, 337–38, 739 N.Y.S.2d 177 (2d Dep't 2002) (client and potential client names, addresses, contact names compiled through considerable effort over several years and not available to the public are trade secrets warranting protection)

Limits on the Protection of an Employer's Client Base

- A covenant will be rejected as overly broad, however, if it seeks to bar the employee from soliciting or providing services to clients with whom the employee never acquired a relationship through his or her employment or if the covenant extends to personal clients recruited through the employee's independent efforts

When New York's Courts May Extend the Non-Compete

- Fired "For Cause"
- Employee Choice Doctrine
- Extenuating Circumstances
  - ❑ Mohawk Doctrine

When an Employee is Fired

- For Cause
- Not “For Cause”

Employee Choice Doctrine

The Employee Choice doctrine provides that an employer can enforce a non-compete against an employee – even post-termination – if the employee accepts post-employment severance or benefits in exchange for honoring the non-compete.

> "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 (*see Kristt v. Whelan,* 4 A.D.2d 195, 199, 164 N.Y.S.2d 239 [1st Dept.1957], *affd. without op.* 5 N.Y.2d 807, 181 N.Y.S.2d 205, 155 N.E. 2d 116 [1958]; *see also Post,* 48 N.Y.2d at 88-89, 421 N.Y.S.2d 847, 397 N.E.2d 358).
>
> "It assumes that an employee who leaves his employer makes an informed choice between forfeiting his benefit or retaining the benefit by avoiding competitive employment (*Kristt,* 4 A.D.2d at 199, 164 N.Y.S.2d 239)."

Employee Choice Doctrine

"Although New York courts have not sketched out every detail of the employee choice doctrine, three strokes are bold and clear.

First, an employer can rely on the doctrine only if it can demonstrate its continued willingness to employ the party who covenanted not to compete. *Post,* 421 N.Y.S.2d at 849, 397 N.E.2d 358.

Second, when an employee is involuntarily discharged without cause, the employer cannot invoke the benefits of the doctrine. *Id.* Enforcing the non-competition provision under such circumstances would be "unconscionable" because it would destroy the mutuality of obligation on which a covenant not to compete is based.

Third, the factual determination whether an employee was involuntarily terminated is generally not appropriate for summary judgment.

Lucente v. IBM, 310 F.3d 243, C.A.2 (N.Y.),2002.

Extenuating Circumstances

- Courts do not like to re-write contracts – can't get more than what you bargained for
- But …. in *New York Real Estate Inst., Inc. v. Edelman,* 42 A.D. 3d 321, 839 N.Y.S.2d 488 (1st Dept. 2007), the court noted that the "**defendant hid his ownership interest in the competing** ... [**business**] **for the entire two-year duration of the non-compete agreement**," and there was undeniable proof that he was competing unfairly.

Extenuating Circumstances

- Mohawk Doctrine
  - ❑ Although restrictive covenants in employment contracts and in contracts for the sale of a business are subject to the same basic test, a stricter standard applies to restrictive covenants in employment contracts. *See, e.g.,* *Purchasing Assocs. v. Weitz,* 13 N.Y.2d 267, 246 N.Y.S.2d 600, 196 N.E 2d 245 (1963).
  - ❑ *GoSmile v. Levine*

When (and how) Employees Can Form a Competing Business

- Fiduciary Duty
  - Generally, an employee may not actively solicit or divert his employer's clients (or proprietary information) while still employed.
  - **HOWEVER**, he may form a competing business *even before leaving his job* so long as he does so on his own time, in his own place and on his own nickel.
- Active vs. Passive Solicitation

When New York's Courts Are Unlikely to Enforce a Non-Solicit

- An employer many not use a non-solicitation agreement to prevent a former employee from dealing with the employer's entire client base, including clients that the defendant never serviced, nor acquired any relationship with while employed by the company. See, e.g., *Stackrow & Co. v. Skavina*, 9 AD3d 805, 806 (3d Dept. 2004); *Good Energy, L.P. v. Kosachuk*, 49 AD3d 331, 332 (1st Dept. 2008).

New York's Courts Are Unlikely to Throw Out the Baby with the Bathwater

- Blue-lining
- *Crossroads, ABL, LLC v. Canaras Capital*:
  - "Since there is no practical temporal limitation contained in the provision, this covenant would prohibit [plaintiff] from competing with [defendants] indefinitely, so long as its membership interest remained above 15 percent. Furthermore, there is no geographic limitation provided. *There has been no request to modify, or "blue-pencil" this provision, and I decline to do so sua sponte."*

What an Employer Should Do When the Non-Compete/ Non-Solicit Has Been Breached

- Seek an Injunction Barring Employee From Working for Competitor
- Employer can seek to recoup money it paid to the disloyal employee
- Employer Can Try to Claim Catch-All of "Unfair Competition"
- Employer can seek lost profits
- Employer can seek liquidated damages
- Employer can't seek damages for "unjust enrichment"

The Challenges to Securing an Injunction/TRO

- 3-Part Test ; (1) a likelihood of success on the merits of the action; (2) the danger of irreparable injury in the absence of preliminary injuctive relief; and (3) a balance of equities in favor of the moving party. See, e.g., Nobu Next Door, LLC v. Fine Arts Housing, INC., 2005, 4 N.Y.3rd 839, 840, 800 N.Y.S.2d.48, 49, 833 N.E.2d 191, 192. In applying these requirements, the court must "weight a variety of factors," and the matter is commited to the court's sound discretion. Dow c. Axelrod, 1988, 73 N.Y.2d 748, 750, 536 N.Y.S.2d 44, 45, 532 N.E.2d 1272, 1272.
- Irreparable Harm

  "The Second Circuit has recognized that damage to one's business reputation and loss of customer goodwill can constitute irreparable harm. *Xelus, Inc. v. Servigistics, Inc.*, 371 F.Supp.2d 387, 390 (W.D.N.Y. 2005) (citing *Register.Com, Inc. v. Verio, Inc*., 356 F.3d 393, 404 (2d Cir. 2004)); see also *Ticor Title Ins. Co. v. Cohen*, 173 F.3d 63, 69-70 (2d Cir. 1999) (it is "very difficult to calculate monetary damages that would successfully redress the loss of a relationship with a client that would produce an indeterminate amount of business in years to come").

- On the other hand …

The Defenses an Employee Will (or Should) Raise to the TRO

- No Trade Secret

  Xerox Corp. v. IBM Corp., 64 F.R.D. 367, 371 (S.D.N.Y. 1974) ("[t]he burden is upon the plaintiff to specify [the alleged trade secrets], not upon the defendant to guess at what they are")

- Unclean Hands
- "I was fired"

Employee Claims He Was Fired

- Actual Termination

  - "New York courts 'will not enforce a non-competition provision in an employment agreement where the former employee was involuntarily terminated.' *SIFCO Indus., Inc. v. Advanced Plating Techs., Inc.,* 867 F.Supp. 155, 158 (S.D.N.Y.1994); *see Post v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 48 N.Y.2d 84, 421 N.Y.S.2d 847, 397 N.E.2d 358, 361 (1979).

  - On the other hand, the Second Circuit in H*yde v. KLS Professional Advisors Group, LLC,* stated as follows:

    "In the interest of judicial economy, however, we note our reservation about the district court's preliminary interpretation of New York law. Relying on *Post v. Merrill Lynch, Pierce, Fenner & Smith,* 48 N.Y.2d 84, 421 N.Y.S.2d 847, 397 N.E.2d 358 (1979), the district court concluded that restrictive covenants are per se unenforceable in New York against an employee who has been terminated without cause. But in *Post,* the New York Court of Appeals held only that when an employee was terrminated without cause, the employer could not condition the employee's receipt of previously earned pension funds on compliance with a restrictive covenant. *Id.* at 89, 421 N.Y.S.2d at 849, 397 N.E.2d 358. We caution the district court against extending *Post* beyond its holding, when a traditional overbreadth analysis might be more appropriate. *See BDO Seidman v. Hirshberg,* 93 N.Y.2d 382, 392–93, 690 N.Y.S.2d 854, 858–59, 712 N.E.2d 1220 (1999)."

What an Employee Can Claim As Damages Against an Over-Zealous Former Employer

- ❑ Tortious Interference With Contract
- ❑ Tortious Interference With Prospective Advantage

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