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Check Your Employment Agreement's Restrictive Covenant

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A recent decision by the U.S. District Court for the Southern District of New York in *Flatiron Health, Inc. v. Carson*[1] found that an employer's restrictions on a former employee were unenforceable. This case highlights a knot that has formed in the law of non-compete agreements. To untangle the knot, a trial court must look past an accumulation of other trial court decisions, to the appellate decision that started it all. That is what the federal trial court effectively did in this case.

The Law of Restrictive Covenants

Contract law treats employee non-compete agreements differently than other agreements. In New York, as in many other states, these agreements are looked at unkindly. It is not infrequent that an employer is unable to enforce a non-compete agreement.

More generally, these kinds of agreements are called *restrictive covenants in employment contracts*. This covers two kinds of agreement that often come up. One kind is non-compete agreements, because the employer has said to the employee, "After you leave, do not compete with me." The other kind is non-solicitation agreements, because the employer has said to the employee, "After you leave, just don't pitch to my customers or entice away my employees." Both of these kinds of agreements are a restrictive covenant in an employment contract.

There are restrictive covenants in other kinds of contracts too. A lease, a sale of a business, and many other kinds of contract may include a restrictive covenant. But here we discuss only restrictive covenants in employment contracts.

Some states have enacted statutes dealing with these agreements. New York is not one of those states. In New York, the strictures on these agreements are set forth in case law. The cases go at least as far back as seventeenth century England.

At present, the most important case defining New York law in this field is a 1999 decision by New York's highest court. This case, *BDO Seidman v. Hirschberg*,[2] articulated the general framework within which New York courts must approach these agreements when asked to enforce one. The framework may not be perfect. Some parts may be vague. Other parts may seem redundant.

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[1] No. 19 Civ. 8999, 2020 WL 1643396 (S.D.N.Y. Apr. 1, 2020).

[2] 712 N.E.2d 1220 (N.Y. 1999).

Regardless, if New York law governs, then this framework provides the language that must be spoken.

In a nutshell, the court evaluating an employer's attempt to enforce one of these agreements will consider four points. On each point, it will be the employer's burden to show that the agreement passes muster. These are not factors that are weighed against each other; rather, all four points must be satisfied. The four points are:

1. Is the agreement limited to a time and place that is reasonable?

2. Does the agreement place a burden on the former employee – make her life difficult – to an extent that is unreasonable?

3. Does the agreement hurt the interests of the general public?

4. As stated by the Court of Appeals in *BDO Seidman*, with italicization as it originally appeared in the opinion: "[I]s [the agreement] *no greater* than is required for the protection of the *legitimate interest* of the employer"?[3]

There is a lot to be said about each of these four points. Here we will discuss only the fourth one.

The obvious question is, what counts as an employer's "legitimate interest"? The answer to that question was uncertain when *BDO Seidman* was decided. Just two months earlier, the Second Circuit, surveying the New York cases, had concluded that there are three possible legitimate interests, and then observed that one of those three was "unclear."[4] It said that "enforcement" of a restrictive covenant

> will be granted to the extent necessary (1) to prevent an employee's solicitation or disclosure of trade secrets, (2) to prevent an employee's release of confidential information regarding the employer's customers, or (3) in those cases where the employee's services to the employer are deemed special or unique.[5]

That third one – "special or unique" employees – was the "unclear" one.

[3] *Id.* at 1223. In the original statement of this framework, the first and second points were combined. In subsequent cases, however, they have sometimes been stated as separate points, making a total of four. *See, e.g.*, *Markets Group, Inc. v. Oliveira*, No. 18 Civ. 2089, 2020 WL 820654, at *11 (S.D.N.Y. Feb. 3, 2020) (listing four points).

[4] *Ticor Title Ins. Co. v. Cohen*, 173 F.3d 63, 71 (2d Cir. 1999).

[5] *Id.* at 70.

As if on cue, the decision in *BDO Seidman* addressed that puzzle. *BDO Seidman*, plus the Second Circuit's decision two months earlier, and cases that followed, articulated a concept of "special or unique" employees that is now a central part of the law. These employees are professionals in relationship-driven fields. The upshot was well stated by a federal judge five years later: In certain kinds of professional fields, "an employer . . . has a legitimate interest in *protecting client relationships developed by an employee at the employer's expense.*"[6]

Note the crucial caveat: "*developed . . . at the employer's expense*." This was the point on which *BDO Seidman* turned. In that case, an accounting firm had imposed a restrictive covenant on one of its accountants. He had left the accounting firm, and the restrictive covenant said he would be penalized if he were to "serve[] any former client" of the firm within 18 months of his leaving.[7] Evaluating that restrictive covenant, the Court of Appeals wanted to know, how had the accountant developed his relationship with the firm's former clients? If he had developed the relationship by doing work for the client that the accounting firm told him to do, then that was one thing. He could be penalized for taking those clients. But if he had developed the relationship with the accounting firm's former client by his own independent efforts, even while he was working at his old accounting firm, then that that was another thing. The accounting firm had no legitimate interest in preventing him from taking that client.[8]

In *BDO Seidman*, the restrictive covenant made no distinction. So it went too far.

<u>Partial Enforcement</u>

Since New York law takes a strict approach to restrictive covenants in employment agreements, New York has a special rule for what happens when one of these agreements goes beyond the law's strictures. Sometimes – not always – the unlawful restrictive covenant is still enforceable *in part*.

If restrictive covenants were always enforceable just up to the part where they go beyond the law's strictures, then we would expect employees regularly to find outrageously excessive language in their employment agreements. *After all*, every employer will think, *why not make the employee agree to more? Let the courts prune it later, if the employee dares to ask a court.* To avoid that incentive, the law gives courts discretion to reject a restrictive covenant in its entirety.

BDO Seidman established the standard for deciding whether an agreement should be pruned and partially enforced or whether it should be rejected in its entirety. In essence, the court must consider whether the employer is a straight shooter.

[6] *Johnson Controls, Inc. v. A.P.T. Critical Sys., Inc.*, 323 F. Supp. 2d 525, 534 (S.D.N.Y. 2004) (emphasis added).

[7] 712 N.E.2d at 1222.

[8] *Id.* at 1225.

> [I]f 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.[9]

Twenty-one years later, this remains the standard. An unenforceable restrictive covenant will survive in truncated form or die completely, depending on whether the employer seems to use sharp dealing.

The Knot

In *BDO Seidman*, the Court of Appeals declared that the accounting firm's restrictive covenant should be enforced in part rather than thrown out entirely. This made sense because before *BDO Seidman* there was no rule against penalizing an employee for taking a firm client that he had developed by his own efforts. The employer could hardly be faulted for having flouted that rule.

In the years that followed, however, lower courts following the guidance provided by *BDO Seidman* often made the Court of Appeals' forgiving attitude in that case into a new rule. Case after case followed in which a trial court noted that the non-solicitation agreement before it overreached because it applied to *all* the employer's clients – even sometimes to the employer's "potential" clients – but the trial court, purporting to follow *BDO Seidman*, declared that it would sever the unenforceable part and enforce the rest.

A string of cases involving a non-solicitation agreement imposed by the Marsh & Mclennan companies on their employees illustrates the development. In these cases, the non-solicitation agreement applies to any client or potential client with whom the employee had contact, regardless of how the contact initiated. As one trial court noted, this appears to go beyond the strictures set by *BDO Seidman*, but that court also indicated that it would partially enforce the non-solicitation agreement.[10] Trial court decisions favoring the Marsh & Mclennan companies accumulated,[11] and

[9] *Id.* at 1226.

[10] *Marsh USA Inc. v. Schuhriemen*, 183 F. Supp. 3d 529, 533-535 (S.D.N.Y. 2016)

[11] *See Schuhriemen*, 183 F. Supp. 3d at 535; *see also, e.g., Marsh & Mclennan Cos. v. Feldman*, Index No. 652284/2019, 2019 WL 470381, at *4 (N.Y. Sup. Ct., N.Y. County Sept. 30, 2019); *Marsh USA Inc. v. Karasaki*, 2008 WL 4778239, at *21 (S.D.N.Y. Oct. 31, 2008).

in March 2020 those decisions were cited by the New York County Commercial Division as persuasive authority in support of favoring the Marsh & Mclennan companies once again.[12]

The Court of Appeals' one-off show of leniency in *BDO Seidman* appears, thus, to have ossified into a new rule.

The Decision in *Flatiron Health, Inc. v. Carson*

This brings us to the decision in *Flatiron Health, Inc. v. Carson*. This case involved yet another overreaching non-solicitation agreement. The employee had signed an employment agreement saying that, for the first year following the end of his employment, he would not "do anything to divert or attempt to divert from the Company any business of any kind, including, without limitation, solicit or interfere with any of the Company's customers, clients, members, business partners or suppliers."[13] Rejecting the employer's attempt to enforce this agreement, the court noted the rule established long ago in *BDO Seidman*: The agreement overreaches because it is not limited to client relationships developed at the employer's expense. To the contrary it covers all clients.[14]

And the court would not forgive the employer. This restrictive covenant would not be partially enforced. The court noted that it must have been obvious to the employer that its restrictive covenant went too far.[15] Indeed, twenty-one years have passed since *BDO Seidman*.

Takeaway

Employers should review their standard employment agreements and make sure any restrictive covenants stay within the strictures set by *BDO Seidman*. While it is not impossible that an overreaching restrictive covenant will be pruned and partially enforced, this should not be the expectation.

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[12] *See King v. Marsh & Mclennan Agency, LLC*, Index No. 653707/2019, 2020 WL 1498537, at *4 - *5 (N.Y. Sup. Ct., N.Y. County Mar. 27, 2020) (noting "the likelihood that the Court will find the [non-solicitation] clause enforceable, as so many other courts have apparently done in the cases cited by Marsh . . .").

[13] No. 19 Civ. 8999, 2020 WL 1643396, at *7 (S.D.N.Y. Mar. 20, 2020).

[14] 2020 WL 1643396, at *23 ("This non-solicitation clause is . . . overbroad because, for example, it makes no distinction between those customers with whom [the employee] developed a relationship by virtue of his work for [the employer] and those with whom he did not.").

[15] 2020 WL 1643396, at *24.

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