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NEW YORK COURT OF APPEALS STRENGTHENS "EMPLOYEE CHOICE DOCTRINE", PROVIDING FOR FORFEITURE IN THE EVENT OF COMPETITION BY A FORMER EMPLOYEE

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In a recent decision, the New York Court of Appeals held that in the context of New York's employee choice doctrine, the constructive discharge test is the appropriate legal standard to apply when determining whether an employee voluntarily left employment or was involuntarily terminated. *See Morris v. Schroder Capital Mgmt.*, 2006 N.Y. Slip. Op. 08638, 2006 WL 3359077 (N.Y. Nov. 21, 2006). By applying this standard in the forfeiture for competition agreement arena, the court strengthened a tool that an increasing number of employers use to prevent damaging competition by former employees. In addition, the Court of Appeals reaffirmed what many courts before it had concluded: Forfeiture for competition agreements are enforceable without regard to reasonableness.

Attached is an article about the *Morris* decision by our Labor and Employment Group Counsel Fagie Hartman, which was published in the *New York Law Journal* on December 15, 2006. It discusses forfeiture for competition agreements generally, describes the *Morris* decision, and considers its importance and effects.

For further information about these developments or to obtain a copy of the *Morris* decision, please contact J. Scott Dyer (jdyer@stblaw.com), Fagie Hartman (fhartman@stblaw.com) or Julie Levy (jlevy@stblaw.com) by e-mail or at (212) 455-2000.

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OUTSIDE COUNSEL

BY FAGIE HARTMAN

Noncompetes With No Reasonableness Hurdles

New York employers have much to be grateful for this holiday season and the New York Court of Appeals' recent decision in *Morris v. Schroder Capital Management*[1] may well be high on the list.

Indeed, the news just keeps getting better for employers who enter into forfeiture for competition agreements to protect against the potentially damaging consequences of an employee jumping ship for a competitor. These agreements, and the "employee choice doctrine" upon which they rely, are for good reason becoming the doctrine of employer's choice.

Traditional noncompete agreements seeking to prevent an employee from competing with a former employer are slippery creatures of law—hard to draft properly and even harder to enforce consistently. Each element of a valid noncompete—that it protects a legitimate business interest, that it is geographically and temporally reasonable, and that it is not an undue hardship to the employee—is subject to its own murky and imprecise analysis.

And, in a litigation to enforce an agreement against a sympathetic employee, which often takes place years after the agreement was executed, each element can pose a minefield of factual uncertainties and legal ambiguities, with the most difficult battles usually fought over whether the restrictions at issue are "reasonable." For every case in which noncompete restrictions were held reasonable, an advocate can find a case with similar facts in which the noncompete was resoundingly rejected by a judge who, for reasons not readily apparent, was unpersuaded by what appeared to be clear precedent.

Much of the law is inconsistent, and, notwithstanding the few bright-line rules in this area, it has generally been impossible for a New York employer to enter into a post-employment noncompete agreement with an employee and rest comfortably knowing that the agreement will be enforced.

Enter forfeiture for competition agreements—agreements in which an employee is

entitled to certain post-employment benefits only if he does not, for a limited period of time, work for a competitor after termination of employment. As an alternative to traditional noncompetes, forfeiture for competition agreements have provided employers with a reliable mechanism for effectively preventing damaging competition by former employees. And now, with the *Morris* decision, New York's highest court has significantly strengthened this important weapon in employers' arsenals by adopting an employer-friendly standard expanding the applicability of these agreements.

With 'Morris,' New York has strengthened forfeiture for competition agreements in employers' arsenals by adopting an employer-friendly standard expanding the applicability of these agreements.

No Reasonableness Hurdle

• *Forfeiture for Competition Agreements: Noncompetes Without the Reasonableness Hurdle.* Notwithstanding the reluctance of New York courts generally to enforce traditional noncompetes, New York law has been remarkably consistent in enforcing agreements conditioning post-employment payments on noncompetition and has required forfeiture of payments made in the event of competition. Indeed, one court has characterized New York as "perhaps the leading 'enforcement' jurisdiction" of such provisions. See *Schlumberger Tech. Corp. v. Blaker*, 859 F2d 512, 516 (7th Cir. 1988).

In 1958, the New York Court of Appeals affirmed an appellate court decision which held that it was permissible for an employer to provide that an employee's entire interest in a profit sharing trust would be forfeited should the employee engage in competition with his former employer. See *Kristt v. Whelan*, 155 NE2d 116 (NY 1958). The *Kristt* court reasoned:

> It is no unreasonable restriction of the liberty of a man to earn his living if he may be relieved of the restriction by forfeiting a contract right or by adhering to the provisions of his contract…. The provision for forfeiture here involved did not bar plaintiff from other employment. He had the choice of preserving his rights under the trust by refraining from competition with [his former employer] or risking forfeiture of such rights by exercising his right to compete with [his former employer]. *Kristt v. Whelan*, 164 NYS2d 239, 243 (App. Div. 1957), aff'd, 155 N.E.2d 116 (N.Y. 1958).

Thus began the "employee choice doctrine" in New York.

In what was perhaps the greatest "gift" to employers in this area, courts have held that forfeiture for competition agreements are enforceable without regard to the reasonableness of the underlying noncompete agreement. See, e.g., *Int'l Bus. Machs. Corp. v. Martson*, 37 FSupp2d 613, 619 (SDNY 1999); *Lucente v. Int'l Bus. Machs. Corp.*, 310 F3d 243, 254 (2d Cir. 2002). Alas, freedom from the subjectivity and unpredictability of the reasonableness analysis.

'Willingness to Employ'

• *The One Catch: The "Willingness to Employ" Factor.* New York courts placed one significant limitation on the employee choice doctrine: The doctrine will only be applied where the employee truly has a choice, i.e., that he left his job voluntarily and the employer was otherwise willing to continue employment. See *Post v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 48 NY2d 84, 89 (1979); see also *Martson*, 37 FSupp2d at 620 ("the

Fagie Hartman *is counsel within the labor and employment group of Simpson Thacher & Bartlett and specializes in post-employment noncompetition law.*

only bar to applying the employee choice doctrine here would be if Mr. Martson had been involuntarily terminated from his job at IBM"); *Lucente*, 310 F3d at 255. Thus, where an employee has been involuntarily terminated, the thorny reasonableness standard once again surfaces, and the employer will not be able to enforce a forfeiture provision unless the underlying noncompete satisfies all the elements of that standard.

This "willingness to employ" limitation can be a vexing problem for employers in situations where an employee's departure, while not clearly a termination by the employer, took place after an event that the employee considered tantamount to a termination, such as a disciplinary action or undesirable change in job duties. Employers were often left with a nagging concern that an employee might be able to persuade a court that, since he did not have the opportunity to continue employment in the manner in which he wanted or expected to, the employee choice doctrine should not apply, thrusting the employer back into the murky reasonableness analysis.

This concern became a reality for one investment banking company that had conditioned approximately $2.9 million of an employee's deferred compensation on his promise not to engage in post-employment competition. And it was in this situation that the Court of Appeals came down squarely on the side of employers and held that, for purposes of the employee choice doctrine, an employee's disenchantment with his employer's decisions does not an involuntary termination make. *Morris*, 2006 WL 3359077.

The 'Morris' Case

Paul Morris was hired by Schroder Capital Management North America Inc., (SIMNA), an investment banking and asset management company, as senior vice president with responsibility for investment management. Mr. Morris was paid an annual salary plus a year-end bonus, a portion of which was deemed a deferred compensation award that would not vest until three years after the date of issue. The plans governing these awards had forfeiture clauses providing that if Mr. Morris resigned and competed with SIMNA before the awards vested, all deferred compensation would be forfeited.

Prior to the vesting of his bonuses, Mr. Morris resigned from SIMNA and established a hedge fund. SIMNA notified him that he had forfeited his deferred compensation benefits by engaging in a competitive business.

Mr. Morris commenced an action in federal district court against SIMNA arguing that he did not leave his job voluntarily and that SIMNA had forced his departure by reducing the amount of assets over which he had control from approximately $7.5 billion to $1.5 billion, thus significantly diminishing his job responsibilities. Arguing that SIMNA placed him in a "dead-end job," Mr. Morris claimed that he had no choice but to resign and that, therefore, SIMNA should not be permitted to rely on the employee choice doctrine to enforce its forfeiture for competition agreement.

The district court dismissed Mr. Morris's claim, holding that because he was not involuntarily discharged, SIMNA's forfeiture agreement was protected by the employee choice doctrine. Noting that the case turned on whether he had voluntarily or involuntarily left his employment, the court borrowed the constructive discharge test from federal employment discrimination law and held as a matter of law that, even taking all factual allegations as true, Mr. Morris could not state a claim of constructive discharge because he did not meet the requisite standard, i.e., his "working conditions at the time of his resignation were not so intolerable that a reasonable person would have been forced to leave the job." *Morris v. Schroder Capital Mgmt. Int'l*, 2005 WL 167608, at *4 (SDNY Jan. 25, 2005).

Mr. Morris appealed to the U.S. Court of Appeals for the Second Circuit, which stated that the narrow question before the court was whether involuntary termination in the context of New York's employee choice doctrine should be governed by the federal constructive discharge test. The Court certified the following questions to the Court of Appeals: (1) Is the factual determination of "involuntary termination" under the New York common law employee choice doctrine governed by the constructive discharge test from federal employment discrimination law, and (2) If not, what test should apply?

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The employee argued before the Court of Appeals that the correct standard is whether the employer is willing to employ the employee in the same or comparable job; the employer argued that the correct standard is the federal constructive discharge test. The impact of the Court's decision in this regard was to be significant. Injecting the necessarily imprecise element of job comparability into the employee choice doctrine would have rendered forfeiture for competition agreements, like traditional noncompetes, subject to ambiguous and subjective considerations, making enforcement unpredictable at best.

Rescuing the employee choice doctrine from this potential morass, the Court of Appeals adopted the employer's view and held that the federal constructive discharge test is the governing standard for the employee choice doctrine. Constructive discharge occurs, stated the Court, "when the employer, rather than acting directly, deliberately makes an employee's working conditions so intolerable that the employee is forced into an involuntary resignation." And, employers need not be concerned that the courts will consider the unique sensitivities of each individual employee. Under this employer-friendly standard, a constructive discharge claim requires "work conditions 'so intolerable that a reasonable person in the employee's position would have felt compelled to resign.'" *Ferraro v. Kellwood Co.*, 440 F3d 96, 101 (2d Cir. 2006). Moreover, "the actions of the employer in creating the intolerable workplace condition must be deliberate and intentional."

Finally, the Court reaffirmed as black letter law a phrase that employers cannot hear too often: Post-employment noncompetes in forfeiture agreements will be enforced "without regard to reasonableness."

Looking Ahead

Collective sighs of relief abound for employers seeking reliable noncompetition agreements with departing employees. No more worries that the disciplined employee who leaves in a huff, or the employee who is dissatisfied with his role following a corporate restructuring, can depart and rob his employer of the security of a well-drafted forfeiture for competition agreement. For employees, however, this decision broadens the circumstances in which forfeiture agreements will be enforced and underscores the importance of thoughtful, protective drafting and carefully timed departures.

Ultimately, however, employees may have even more to grapple with, if employers seek to push forfeiture doctrine even further. Emboldened by the Court's decision, some employers may find that one question begs asking: Can there be a valid forfeiture for competition agreement in which the parties agree that after termination of the employee's employment for any reason—including involuntary termination—the employee's entitlement to certain post-employment benefits is contingent upon him not competing with his former employer, even absent a finding of the noncompete's reasonableness? Is there a compelling reason, they would argue, that this type of commercial agreement, between sophisticated parties who can choose to agree or not depending on the benefit being provided, should be invalid as a matter of law?

While this result would be contrary to the New York rule that traditional noncompete agreements are unenforceable in a not-for-cause termination, see *SIFCO Indus., Inc. v. Advanced Plating Techs., Inc.*, 867 FSupp 155, 158 (SDNY 1994), courts might see it differently in the forfeiture context, where the employee is not prevented from entering into gainful employment. Indeed, the Court of Appeals may have alluded to this possibility in its *Post* decision, which noted that the pension plan at issue there, which mandated forfeiture by participants who engaged in competition, was not explicitly drawn to cover employees whose employment had been involuntarily terminated. See *Post*, 48 NY2d at 88-89. Accordingly, the Court went on to say, it "need not consider now what would have been our decision had the draftsman of this pension plan manifested an unmistakable intention to impose the heavy penalty of forfeiture for engaging in competition *even after discharge of an employee without cause*." Id. (emphasis added).

Heavy penalty? Perhaps. Invalid as a matter of law? Perhaps not.

1. 2006 N.Y. Slip. Op. 08638, 2006 WL 3359077 (N.Y. Nov. 21, 2006).

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