New York Law Journal

Page printed from: New York Law Journal

Outside Counsel

Demotion May Vitiate Non-Compete, But What of Non-Solicit Clause?

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August 10, 2015

Earlier this year, New York's Appellate Division, First Department, went out of its way to state that demoting an employee can, in some circumstances, invalidate that employee's noncompete clause. Fewer v. GFI, 124 A.D.3d 457, 2015 WL 176227 (1st Dept. 2015).

But the question that the appellate court chose not to answer is probably more telling: Will demoting an employee also invalidate the employee's non-solicit clause?

Factual Background

Back in 1996, Donald Fewer accepted a job as the head of Jersey Partners Inc.'s (JPI) (GFI's predecessor) North American credit derivatives desk. Upon acceptance of the job, Fewer signed an employment agreement which included a non-compete clause barring Fewer from competing in the New York metropolitan area for a period of 190 business days posttermination. His agreement also contained a non-solicitation provision prohibiting him from soliciting fellow employees for 1 1/2 years post-employment, and from soliciting JPI clients with whom he had worked for 260 days post-employment.

Four years later, Fewer was promoted, and was charged with oversight of GFI's entire North American brokerage business. In conjunction with the promotion, Fewer signed two stock option agreements that included longer non-competition provisions than the ones he had previously signed.

In 2007, GFI demoted Fewer, taking away his responsibility for oversight of GFI's North American brokerage business, and also required Fewer to report to his replacement. In April 2008, Fewer notified GFI that he would not extend his employment agreement, and five months later, Fewer took a job with Standard Credit Securities, a direct competitor of GFI.

The Trial Court's Decision

Rather than waiting to be sued by GFI, Fewer proactively sought a judicial declaration that his non-compete and non-solicitation clauses were unenforceable. GFI counterclaimed for

damages flowing from Fewer's breaches of his employment agreement, with causes of action for breach of contract and breaches of his duty of loyalty.

Following extensive discovery, both sides cross-moved for summary judgment, and the trial court sided with Fewer on most of the issues, dismissing several of GFI's counterclaims based upon its finding that Fewer's demotion constituted a material breach of his employment agreement, rendering his non-competition covenant unenforceable.

The court further held that by terminating Fewer's stock options, GFI effectively waived its right to rely upon the employee choice doctrine as a mechanism to enforce the non-compete because unlike the standard case where the employee knowingly chooses to comply with postemployment restrictions in exchange for certain benefits, here, Fewer had already bought and paid for the subject stock options.

Appellate Court Decision

On appeal, the Appellate Division, First Department, modified the trial court's holding, restoring a number of GFI's counterclaims on the grounds that they could not be determined as a matter of law based upon the facts presented on this record, but as a practical matter, left the trial court's findings largely intact.

More specifically, the Appellate Division turned back GFI's attempt to hold Fewer to his noncompete, holding that by replacing Fewer as the person in charge of the day-to-day operations of its North American brokerage business, limiting his responsibilities to the North American credit business, and requiring him to report to his replacement (and thereby diminishing his rank and role in the company), GFI could no longer bar Fewer from competing with GFI because the services he was now rendering—unlike those he performed before his demotion— were no longer "unique."

Unfortunately for Fewer, this alone was insufficient to warrant an outright win on his claims, because he waited 15 months before asserting that GFI had breached the parties' agreement by demoting him. As a result, the court felt compelled to leave open the possibility that a trier of fact might view this delay as a waiver of this defense, stating:

> [A] triable issue of fact exists whether plaintiff's 15–month delay in asserting the breach, during which time he continued to perform his duties, was reasonable or, by so delaying, he elected his remedy and may not now assert the breach.

Takeaways of Decision

To be sure, the notion that an employee can waive his employer's breach of the employment agreement is critical; that said, it remains secondary in importance to the two other takeaways of the Fewer decision.

How an Employer's Breach of the Agreement Could Preclude Enforcement of the NonCompete. First, and as a threshold matter, it bears emphasis that an employer can forfeit an otherwise enforceable non-compete by materially breaching the employment agreement, as the court notes:

> The significant change in plaintiff's duties constituted a material breach of his employment agreement.[i]

As a practical matter, the court is making clear that an employer can—and will—be deemed to have "materially breached" the agreement even without firing the employee; demoting him alone is sufficient.

The Employer's Breach Renders Moot the Employee Choice Doctrine. Second, and equally important, the court held that by cancelling Fewer's stock options, GFI inherently forfeited its right to rely upon the "employee choice doctrine" to establish the enforceability of the non-solicitation provisions of the employment agreement, and thereby lost what is, perhaps, the most potent weapon in its arsenal. The court stated:

> JPI's cancellation of plaintiff's shares of company stock without compensation renders the "employee choice" doctrine inapplicable to the nonsolicitation covenants in the option agreements.

Naturally, this short line, which is buried near the end of the decision, is crucial, because the employee choice doctrine holds that an employee is precluded from arguing over the reasonableness (or, more accurately, the lack thereof), of a restrictive covenant when the employee receives post-employment compensation in exchange for signing the agreement.[2]

Seeking More Clarity

Unfortunately, the Fewer decision leaves open the question (at least in the First Department's view) as to whether an employer's breach of the employment agreement can, assuming an employee does not waive his claim that he was constructively terminated, automatically vitiate his non-solicitation provision. As this author has noted elsewhere,[3] the Appellate Division, Fourth Department,[4] has apparently followed the U.S. Court of Appeals for the Second Circuit's dicta in Hyde v. KLS Professional Advisors Group,[5] stating that:

> Contrary to defendants' contention, this court's decision in Eastman Kodak v. Carmosino, (77 A.D.3d 1434, 909 N.Y.S.2d 247 [2010]) did not extend the Post holding to establish a per se rule that involuntary termination without cause renders all restrictive covenants unenforceable.

However, the Hyde court's strict reading of the Court of Appeals' seminal decision in Post v. Merrill Lynch, Pierce, Fenner & Smith[6] remains at odds with that of several other courts,[7] and also appears at odds with elemental contract principles and policy—i.e., that a party who breaches its end of a contract (in this case, the employer) forfeits the right to hold the other party (in this case, the employee) to their end of the contract.[8]

It is this author's hope that New York's appellate courts will clarify this issue in the near future, for it would provide far greater clarity and predictability to both employers and employees, and thereby (hopefully) reduce litigation and its attendant costs.

Endnotes:

1. Citing Rudman v. Cowles Communications, 30 NY2d 1, 10, 330 NYS2d 33, 280 N.E.2d 867 [1972]; Hondares v. TSS–Seedman's Stores, 151 A.D.2d 411, 413, 543 NYS2d 442 [1st Dept. 1989].

2. 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 NYS2d 239 [1st Dept. 1957], affd. without op. 5 NY2d 807, 181 NYS2d 205, 155 N.E.2d 116 [1958]; see also Post v. Merrill Lynch, Pierce, Fenner & Smith, 48 NY2d 84 at 88-89, 421 NYS2d 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 NYS2d 239).

3. See, Cooper, J., "Decisions Spur Confusion as to Non-Competes," NYLJ, April 28, 2014.

4. Brown & Brown v. Johnson,115 A.D.3d 162, 980 NYS2d 631 (4th Dept. 2014).

5. Hyde v. KLS Professional Advisors Group, 500 Fed.Appx. 24, 2012 WL 4840714 (2d Cir. 2012).

6. Post v. Merrill Lynch, Pierce, Fenner & Smith, 48 NY2d 84, 421 NYS2d 847, 397 N.E.2d 358, rearg. denied 48 NY2d 975, 425 NYS2d 1029, 401 N.E.2d 433.

7. See, e.g., SIFCO Indus. v. Advanced Plating Techs., 867 F.Supp. 155, 158 (S.D.N.Y. 1994); Arakelian v. Omnicare, 735 F.Supp.2d 22 (S.D.N.Y. 2010).

8. See, e.g., Pattern Jury Instruction 4:1; see also, Palmetto Partners v. AJW Qualified Partners, 83 AD3d 804, 921 NYS2d 260 (2d Dept. 2011); JP Morgan Chase v. J.H. Elec. of New York, 69 AD3d 802, 893 NYS2d 237 (2d Dept. 2010); Furia v. Furia, 116 AD2d 694, 498 NYS2d 12 (2d Dept. 1986); see, Dee v. Rakower, 112 AD3d 204, 976 NYS2d 470 (2d Dept. 2013); Ascoli v. Lynch, 2 AD3d 553, 769 NYS2d 567 (2d Dept. 2003).

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