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Non-competition By Employee Choice

By Michael Starr and Amy L. Strauss *

Recognizing the competitive advantage achieved by the talent and business savvy of their key employees, companies today put great stock in non-competition agreements that ban employees from quitting and going to work for a rival. Great pains are put into drafting “reasonable” restrictions in the hope that they will, by virtue of their reasonableness, be judicially enforced. As it turns out, this is often fool's gold. But, under a long-established though oft-overlooked common-law principle that is now known as the “employee choice doctrine,” very powerful non-competition protections can be devised that do not depend on reasonability.

Many go wrong in assuming that if the duration and geographical scope of a non-competition covenant is finely tuned enough, it will be judicially enforced. Under American common law, however, as applied in most states, a non-competition covenant cannot pass the threshold test of reasonability unless it serves the employer's legitimate protectible interest or if the employee's services are unique. *See, e.g., BDO Seidman v. Hirshberg*, 93 N.Y.2d 382, 389 (1999). Thus, employers can enforce non-competition covenants to prevent the misappropriation of trade secrets or confidential customer lists, or to prevent former employees from trading on client relationships that they developed through the resources of their employer. But, the bald desire to prevent a talented individual from quitting to compete with his employer is not recognized as a protectible interest, and a covenant-not-to-compete serving only that end will not be enforced no matter how otherwise “reasonable” it may be.

Forfeiture for Competition

A pragmatic alternative is to link payment of post-employment benefits to an obligation not to quit and compete. Customarily, this is made a provision of the plan providing the benefit, such as a stock option or incentive compensation plan. Under the employee choice doctrine, an employee who leaves the company may choose to accept those benefits from his employer provided she promises not to work for a competitor. If she later changes her mind and accepts a position with a rival firm, she forfeits unpaid benefits and may even be required to pay back what was already received.

An early case to recognize such a forfeiture-for-compensation clause was *Kristt v. Whelan,* 164 N.Y.S.2d 239 (1 st Dep't 1957), *aff'd without opinion*, 5 N.Y.2d 807

(1958). In *Kristt*, an employee was the beneficiary of a pension trust created by his employer. The trust agreement provided in part that if the employee became employed in any competing business, he would forfeit his trust-fund rights. *Id.* at 241. (This was, of course, before ERISA.) When the employee quit his job to open a competing business, the employer invoked the forfeiture clause and had the trust stop payment of the benefits. The appellate court held the forfeiture-for-competition clause to be valid because the employee had "the choice of preserving his rights under the trust by refraining from competition . . . or risking forfeiture of such rights by exercising his right to compete." *Id.* at 243. This holding was based on the hoary rule that "[i]t 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." *Id.*

Applying the principles of *Kristt,* courts in New York and other states have upheld forfeiture-for-competition clauses contained in pension or similar benefit plans. *See, e.g., Rochester Corporation v. W.L. Rochester*, 450 F.2d 118 (4th Cir. 1971)(applying Virginia law); *Dollgener v. Robertson Fleet Services, Inc.*, 527 S.W.2d 277 (Tex. Civ.App. 1975); *Van Pelt v. Berefco, Inc.*, 208 N.E.2d 858 (Ill. Sup. Ct 1965). Courts adopting this view will enforce the clause "*without regard to its reasonableness* if the employee has been afforded the choice between not competing (and thereby preserving his benefits) and competing (and thereby risking forfeiture)." *Lucente v. International Business Machines Corp.*, 310 F.3d 243 (2d Cir. 2002)(emphasis added). In this way, employers may tie post-employment benefits to restrictions on competition, without regard to trade secrets or unique services or whether the restraint is unreasonably burdensome to the former employee.

A forfeiture-for-competition clause is not a covenant not to compete, which means that it may not allow an employer to obtain an anti-competition injunction. As Judge Posner noted in *Sarnoff v. American Home Products Corp.*, 798 F.2d 1075 (7th Cir. 1986) (applying New York Law), "the whole point of *Kristt* was to distinguish between a *covenant* not to compete, whereby a former employee could be enjoined from competing with his former employer, and a *condition* whereby the former employee would merely forfeit a monetary benefit if he went into competition with his former employer" (emphasis added).

Because it may not allow an employer to run to court and enjoin the employee from working for a competitor, a forfeiture-for-competition clause is in some ways less powerful than a covenant not to compete. However, it saves the employer the cost – and potential embarrassment – of providing a departing employee with significant benefits only to have him wind up in a rival's executive suite. Moreover, forfeiture-for-competition clauses have been construed to require the former employee to pay back benefits already received before the prohibited competition began. *See International Business Machines v. Marston,* 37 F.Supp. 2d 613 (S.D.N.Y. 1999). With the amounts of money at stake today in employee stock options and the array of deferred incentive compensation plans (which generally are not subject to ERISA's anti-alienation provisions), the risk of forfeiture can be a powerful disincentive to competition, even without an injunction.

Employee Choice

There is, however, a significant limitation on forfeiture-for-competition clauses in the context of deferred incentive compensation: it must truly be the employee's choice. In *Post v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 48 N.Y. 84 (1979), two employees who had worked as account executives were terminated by

Merrill from their employment and found jobs with a competitor. The company later stopped their benefits under a company-funded pension plan pursuant to its forfeiture-for-competition provisions. While the New York Court of Appeals re-affirmed the validity of a forfeiture-for-competition clause under the reasoning of *Kristt*, it nonetheless held that such clauses could not be enforced "where the termination of employment is involuntary and without cause." *Id.* at 88. It based this rule on the congressional policy against forfeiture of pension embodied in the then recently-enacted ERISA, the fact that the benefit had already been "earned" by the former employees, and on the requirement of mutuality of obligation, which in the context has as "[a]n essential aspect . . . the employer's willingness to employ the party covenanting not to compete." *Id.* at 89.

Some courts have understood the employee-choice doctrine to bar forfeiture for competition whenever the employee is terminated without cause unless employers "demonstrate [a] continued willingness to employ" the individual. *See Lucente, supra* , at 254; *Marston*, *supra*, at 620. But this ignores that *Post* arose in the context of a pension plan whose benefit had already been "earned" by prior service. Such employees give up their pre-existing common law right to compete after their employment has ended (absent theft of trade secrets or other similar misconduct) in consideration of the post-employment benefit, and the employer, the *Post* court held, must also give up its pre-existing common law right to terminate its employees at will. It was for this reason that the New York Court of Appeals insisted that a precondition for an enforceable forfeiture-for-competition clause, in the context of a pension or deferred compensation plan, was that the employer give up its right to terminate at will because the employee's involuntarily termination would "necessarily destroy[] the *mutuality of obligation* on which the covenant rest[s]." 48 N.Y. at 89 (emphasis added).

Discharge and Choice

If this analysis is correct, it raises the possibility that there can be mutuality of obligation and an enforceable forfeiture-for-competition clause even if the employee is terminated without cause, provided that the employee obligates itself to provide benefits that were not previously earned by the employee's service. That could be, for example, the accelerated vesting of stock options that would, under the stock option plan, automatically lapse upon the termination of employment, whether voluntary or not, or just an additional cash payment above and beyond the severance that the employee would otherwise be eligible to receive.

Under these circumstances, the involuntarily terminated employee's choice is not to stay with the employer and preserve the deferred compensation benefit or to quit and forfeit the benefit if he competes. But it does not make the choice any less real. She is free to accept special severance benefits and refrain from competing, or to decline the benefits and find a competitive job. This seems to be squarely in the *Kristt* conceptual paradigm: one can give up his right to ply his trade for a price he voluntarily accepts.

Though simple recitation of a rule that involuntary termination without cause bars application of the employee-choice doctrine is, as explained above, inconsistent with the actual rationale of *Post*, some courts have said so. One case appears to have applied this understanding in the context of a supplemental severance agreement (rather than a deferred compensation plan) and implied — uncritically, we believe — that the forfeiture-for-competition clause of that agreement could

not be enforced if the employee was fired by his employer. *Lucente*, *supra,* 310 F.3d at 257.

With all this mind, employers would be wise to consider including forfeiture-for-competition clauses not only in deferred-compensation or stock option plans, but also in separation agreements or severance packages. Such provisions are surely enforceable as to employees who voluntarily resign and may, as well, for employees who are terminated without cause, though the law on that point is, at this time, unsettled.

Although a forfeiture-for-competition clause may not *prevent* an employee from working for a competitor, it might discourage her from doing so. And, unlike covenants not to compete, employers can use such arrangements without having to show trade-secret misappropriation or unique services.

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