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Ruling Shows New Potential For Retroactive For-Cause Firings

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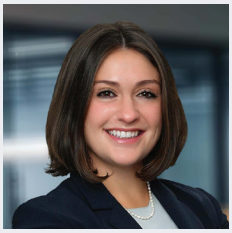

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Oftentimes, employers do not have full visibility into an employee's behavior — including misconduct and actions that would support a so-called for-cause termination — until after that employee has left the company.

The few decisions that have previously addressed whether an employer may retroactively terminate an employee for cause, whether based on evidence discovered after the employee's departure or otherwise, suggest that retroactive terminations for cause are ineffective because they are inconsistent with certain standard contractual provisions.

However, the legal landscape may be changing. A recent decision from the U.S. District Court for the Southern District of New York, Kulick v. Gamma Real Estate LLC,[1] which followed a mid-2022 Delaware Chancery Court decision drawing on a separate but analogous area of employment law, has shed light on this important issue and opened the door to retroactive terminations for cause based on what is known as the after-acquired evidence doctrine.

Kulick may signal a shift in favor of employers in this context, particularly in situations where an employer can demonstrate the former employee actively concealed misconduct that would have supported a for-cause termination.

Background on the Case Law Concerning Retroactive Terminations For Cause

Generally, employers inform terminated employees of the classification of their termination — for cause or not — at the time of the termination decision. Consistent with the fact that employers who later labeled terminations as for-cause presumably announced the original terminations in good faith, courts that have addressed retroactive terminations have generally sided with employees.

In fact, courts have seemed suspicious of the employers' motivations in reclassifying terminations, with, for example, the Supreme Court of the State of New York in Ta-Chotani v. Doubleclick Inc. in 2000 calling the practice "disingenuous,"[2] and the U.S. District Court for the Southern District of New York in 2012 labeling it "nonsensical"[3] in Creditsights Inc. v. Ciasullo.

In these cases, which span the last 20-plus years at the state and federal levels, including as recently as early 2022, courts have declined to permit employers to later assign cause to employees' terminations based on provisions found in governing agreements that require the employer to provide notice and an opportunity to cure any breaches, or on the negotiated terms of a separation agreement.[4]

Accordingly, courts have typically viewed the issue of whether an employee can be retroactively terminated as a contractual issue that should be decided based on the then-existing factual record, not what could have or should have occurred.

The problem with this perspective, however, is that the employers in those cases did not have complete information at the time of the termination because of the employee's alleged misconduct (assuming the employers' allegations were accurate).

To put it another way, the employees escaped for-cause terminations only because the employees were successful in deceiving their employers.

The Kulick Decision's Justification For a Retroactive For-Cause Termination

While the Kulick decision contains similar factual circumstances as the cases that precede it, the outcome was different.

Plaintiff Richard Kulick sought damages in relation to the defendants' alleged scheme to freeze him out of a real estate investment business called GRE JV SLP LLC, or SLP, by repurchasing his membership interests for a penny.

Kulick sought to recoup fees he believed were wrongfully withheld from him following his not-for-cause termination from the joint venture. Specifically, Kulick claimed that he retained an economic interest in income earned by SLP because the defendants had wrongfully assigned cause to his termination after his separation from SLP.[5]

The defendants counterclaimed, seeking a declaratory judgment that they acted in accordance with the terms of the SLP operating agreement, which contained a Delaware choice of law clause, when they assigned cause to Kulick's termination and redeemed his membership interests.

In support of this argument, the defendants contended that Kulick spent his final month of employment advancing the interests of a new, and competing, company by misappropriating SLP's resources, soliciting its investors, and taking its corporate opportunities. The defendants further maintained that Kulick's misconduct during this final month supported claims for breach of fiduciary duty, breach of contract, and unfair competition.

Importantly, the defendants did not assign cause to Kulick's termination until nearly two weeks after his final date of employment, and nearly two months after he was first informed of the termination.

The defendants justified this delay by noting that they had no reason to suspect Kulick of misconduct until the final day of his employment, when they happened to stumble upon an email that detailed his actions. Rather than assign cause in that moment, the defendants pursued "a thorough investigation of what was happening."[6]

The defendants rebutted Kulick's claim that the delay cost them the opportunity to redeem his membership interests by invoking the after-acquired evidence doctrine, which has been typically applied in the employment discrimination context to "allow[] an employer to introduce evidence the employer collected after the discharged employee brings suit for wrongful discharge."[7]

The doctrine allows an employer in a wrongful termination dispute to justify adverse action against an employee, with evidence discovered after the termination that would have provided proper grounds for the discharge, had the employer known of it prior to the termination.

The Kulick Decision's View on Delaware Chancery Court Decision

While the defendants argued that the doctrine had been previously applied in contractual disputes and that, as a result, it should be applied to allow retroactive assignment of cause to Kulick's termination, the court was initially skeptical of this argument. As the court specifically noted in the decision, at the time of summary judgment briefing there was little case law on the doctrine as applied in Delaware, and that which existed was largely distinguishable.

In a stroke of good timing for the defendants, however, the Delaware Chancery Court published a decision with nearly identical facts shortly after the parties' motions for summary judgment were fully briefed, Metro Storage International LLC v. Harron,[8] that led the court to agree with the defendants' application of the after-acquired evidence doctrine to retroactive terminations for cause.

Initially, the court concluded that cause could be assigned to Kulick's conduct because it fit within the SLP agreement's definition of "cause," which includes termination that results from "unethical conduct in the performance of [Kulick's] duties," breaches of the confidentiality covenant, and violations of employee manuals or conduct that is not in the best interests of, among others, SLP.

The court explained that Kulick was "guilty of all these offenses," as he spent his final month of employment misusing the defendants' resources, soliciting investors, and potentially usurping corporate opportunities, all for the benefit of his new company.[9]

In concluding that the after-acquired evidence doctrine could be applied in the context of a retroactive termination for cause, the court relied on Metro Storage. There, an executive resigned from his company to take advantage of an opportunity he learned about when he was improperly providing outside consulting services during his employment.[10]

The company discovered the misconduct only because of its policy that after an employee leaves, the employee's supervisor receives copies of emails addressed to that employee's company email address.[11]

As a result, the company filed suit alleging, among other things, that the executive breached the company's operating agreement by sharing confidential information for a purpose inconsistent with the company's benefit, and sought a declaratory judgment that it could repurchase the executive's units in the company at no cost.

The Chancery Court held that the option could be exercised, despite the requirement that the employer provide the employee with notice and an opportunity to cure before such exercise pursuant to the relevant agreements between the parties, because of the after-acquired evidence doctrine.

In so doing, the Chancery Court noted that the doctrine had typically been limited to claims of wrongful termination, but explained that it "applies all the more persuasively in this setting, where a faithless fiduciary like [the defendant] concealed the wrongdoing that could have supported a for cause termination."[12]

The court further reasoned that if the after-acquired evidence doctrine did not apply, then the executive would benefit from his wrongful acts and be better off for concealing his misconduct.[13]

The unequivocal nature of this holding is one of the features that may have driven the decision in Kulick. As to the notice requirement, the court explained that the executive had engaged in a surreptitious material breach of the relevant agreement between the parties that could have caused the company to exercise the option to repurchase his units.

Accordingly, the court held that, as a matter of equity, the executive could not invoke the timing requirement to exercise the option.[14]

The court noted that the facts in Kulick are closely analogous to those in Metro Storage, as both concern concealed misconduct, including the misuse of confidential information, that was discovered by chance after the employee left the company. In both cases, the company that belatedly discovered the misconduct tried to use it to retroactively assign cause to the wrongdoer's termination to trigger a repurchase provision.

The court went so far as to conclude that the fact that the defendants discovered the email before Kulick left the company and waited over a week to invoke cause was immaterial, as further investigation was needed. The court wrote, "There can be no doubt that Defendants would have terminated Kulick for cause had his misconduct been known from the time it began. Kulick cannot now reap the gains of his concealment."[15]

Based on the above, along with the remainder of the court's analysis on separate issues, U.S. District Judge Mary Kay Vyskocil, for the Southern District of New York, granted the defendants' motion for summary judgment in part and denied Kulick's motion for summary judgment in its entirety.

In so doing, the court, among other things, granted the defendants' claim for a declaratory judgment that they acted in accordance with the terms of the SLP agreement when they retroactively assigned cause to Kulick's termination and redeemed his membership interests for a penny.

Kulick's Practical Impacts

The legality of retroactively assigning cause to an employee's termination, thereby changing that individual's employment status, is likely to have real, meaningful repercussions.

The Kulick court was reticent to apply the after-acquired evidence doctrine in Kulick based on the case law favoring employees that came before it, doing so only after the Chancery Court published its decision in Metro Storage.

Nevertheless, Kulick does appear to answer the question of whether an employer may legally retroactively terminate an employee for cause, based on information later ascertained that would have given rise to a termination for cause had the employer known it at the time, in the affirmative.

This is presumably true even where the relevant agreements between the parties require an employer to provide notice and an opportunity to cure before terminating an employee for cause, as in Metro Storage.

Indeed, in situations where an employee's later-discovered behavior supports termination for cause, such as that employee's corporate theft, violation of company policies, or dereliction of duties, notice is likely to have been futile.

The after-acquired evidence doctrine is largely based on the notion that a disloyal employee should not be permitted to benefit from their own wrongdoing; that merely because the employer did not initially take adverse action against the employee based on their concealed misconduct does not mean that the employee should be, in effect, rewarded for their bad behavior once that misconduct is discovered.

This makes sense, particularly in the context of retroactive terminations for cause — employers often do not learn of an employee's wrongdoing until after that employee is long gone.

In that same vein, employees should not benefit from contractual protections, such as notice requirements, where they were unlikely to have cured their covert breaches, and those breaches were not discovered until after their departure. Still, the potential for employers' abuse of the after-acquired evidence doctrine to reclassify terminations as for-cause is non-negligible.

The decisions preceding Metro Storage and Kulick touched on such possible corporate misconduct, noting that employers should not be afforded the opportunity to take advantage of terminated employees by subsequently assigning cause and clawing back certain severance benefits contingent on terminations being without cause.

Kulick raises additional questions that may be implicated by the application of the after-acquired evidence doctrine to retroactive for-cause terminations. For instance, could a separation agreement that classified an employee's termination as not-for-cause be undone by evidence subsequently discovered?

While the decision did not deal with this situation, the answer would seem to be "yes" based on the logic of Metro Storage. If an employee should not benefit from his or her fraud, that would seem to be true regardless of whether the parties specifically negotiated a separation agreement.

But the same logic could be applied to any contract where one party later discovered fraud; it is unclear why a separation agreement should be treated differently than any other contract.

Conclusion

Both Kulick and Metro Storage, decided in 2022, applied the after-acquired evidence doctrine to situations in which, after an employee leaves a company, the employer discovers through normal due diligence that the employee was engaged in conduct that could give rise to termination for cause.

Both cases ultimately concluded that in such a situation, the employer can retroactively terminate the employee for cause, even where such retroactive classification would have an impact on the former employee's compensation,

including earned stock, and even where the governing agreement between the parties contained a requirement that the employer provide the employee with notice and an opportunity to cure prior to terminating the employee for cause.

These decisions are premised on the idea that former employees should not profit from their misconduct, even if their wrongdoings are not discovered until after they have been terminated.

Nevertheless, these decisions are only two in a previous landscape of opinions disfavoring retroactive terminations for cause as "disingenuous," "nonsensical," and violative of notice and cure requirements. Accordingly, practitioners, employers and employees are likely to feel the effects of these recent decisions as the case law on this subject continues to take shape.

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[1] Kulick v. Gamma Real Estate LLC, 2022 WL 4467341 (S.D.N.Y. Sept. 23, 2022).

[2] Ta-Chotani v. Doubleclick, Inc., 276 A.D.2d 313 (1st Dep't 2000).

[3] Creditsights, Inc. v. Ciasullo, No. 05 CV 9345 (DAB), 2012 WL 12926046, at *6 (S.D.N.Y. Mar. 8, 2012).

[4] See, e.g., Creditsights, 2012 WL 12926046, at *6 ("Whether [employer] could have fired [employee] "for cause" . . . is not relevant, as the unambiguous language of the contracts between the parties indicates that [employee] resigned from [employer]."); Markovits v. Venture Info Cap., Inc., 129 F. Supp. 2d 647, 654 (S.D.N.Y. 2001) (declining to apply the after acquired evidence doctrine because notice of cause, sent more than eight months after employee was terminated, was insufficient to constitute "notice" as required under employment contract); All Vision LLC v. Paduano & Weintraub LLP, 2022 WL 406648, at *1 (N.Y. Sup. Ct. Feb. 09, 2022) (employer could not terminate former employee for cause six months after termination where "notice was required under the [ ] Agreement and that notice was not given," and, in any event, "no cure could have been effected as the [termination for cause] was sent 6 months after termination."); King v. Recreational Equip., Inc., CV 16-27-M-DLC, 2016 WL 8711290, at *1 (D. Mont. Dec. 8, 2016) (under Montana law, an employer cannot rely on reasons justifying a termination unless the employer set those reasons forth in the termination notice);Lohmann v. Towers, Perrin, Forster & Crosby, Inc., Civ. A. No. H-91-3586, 1992 WL 548195, at *1 (S.D. Tex. Oct. 28, 1992) (under Texas law, an employer cannot later justify discharging an employee on grounds that it did not raise at the time of discharge).

[5] See Kulick v. Gamma Real Est. LLC, 2022 WL 4467341, at *1 (S.D.N.Y. Sept. 23, 2022).

[6] Id. at *9.

[7] Id.

[8] Metro Storage International LLC v. Harron, 275 A.3d 810, 835 (Del. Ch. 2022).

[9] Id.

[10] See Metro Storage, 275 A.3d at 835.

[11] See Id. at 836.

[12] See Id. at 879.

[13] See Id.

[14] See Id.at 876-77.

[15] Kulick, 2022 WL 4467341, at *10.