

NEW YORK CONTRACT LAW AND DISPUTES

Form Versus Substance: Termination Procedures in NY Employment Contracts

By Curtis B. Leitner and Trevor J. Larrubia

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In employment contracts, a fundamental employee protection is the right to continued employment absent termination for “cause.” Employment contracts often specify procedures that must be followed to effect a cause termination. If a contract has no termination procedure, it may still incorporate handbooks or policies that provide procedures for employee discipline. The prevalence of employment termination procedures is reflected in the Restatement of Employment Law, which states that a “cause” termination has a “procedural dimension.” Section 2.04(e) of the Restatement states: “When the [employment] agreement specifies termination procedures, those terms control.”

Under New York law, sometimes they do—and sometimes they don’t. Some case law prioritizes procedure—*i.e.*, if the procedure is not followed, the employee prevails regardless of the existence of “cause.” Other case law pri-



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Curtis Leitner ,left, and Trevor Larrubia ,right, of
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oritizes substance—*i.e.*, a procedural breach by the employer only matters if is “material.” This column analyzes competing New York case law and its implications.

The Formalist Position

Under New York law, the employer’s failure to follow contractual termination procedures can have serious consequences—including the obligation to pay out the remainder of the employee’s contract.

In a leading case, *Scudder v. Jack Hall Plumbing & Heating*, 302 A.D.2d 848 (3d Dep't 2003), the COO of the plumbing company had a contract stating that the company could terminate him for cause by presenting written allegations of misconduct, providing him a chance to respond in writing, and then obtaining the board's consent. Based on complaints about the COO's "managerial style," the board voted to terminate him without following the procedure. The COO did not receive written allegations of misconduct or an opportunity to respond.

The Third Department held that the company's "cause" termination was invalid because the company violated the contractual termination procedure. The court reasoned that the company's "demonstrated failure to follow the process outlined in...the employment contract not only lends significant credence to the [COO's] characterization of his termination as a *fait accompli* but, most importantly, renders [his] discharge ineffective."

Further, the court ruled that "whether sufficient cause existed for terminating [the COO's] employment contract...need not detain us." In other words, the company's procedural violation made the existence of "cause"—in a dispute that was *about* a cause termination—irrelevant. The court directed the trial court to calculate the COO's damages on remand, and he was awarded damages based on the compensation and benefits due on the remainder of the contract.

In *Scudder*, the company's failure to follow the termination procedure was not carelessness; the company was actually following legal

advice. The company's counsel advised that, "in view of the urgency caused by the perceived danger to the business," the board could terminate the COO immediately—without waiting for written allegations of misconduct and the COO's response. Having followed that advice, the company was ordered to pay out the COO's contract. Subsequently, the company sued the attorney for malpractice.

In *Jack Hall Plumbing & Heating v. Duffy*, 100 A.D.3d 1082, 1083 (3rd Dep't 2012), the Third Department held that the malpractice claim could proceed to trial. Hence, the company's obligation to strictly follow contractual termination procedures was sufficiently clear to support a malpractice claim.

The Substantive Position

Other courts refuse to elevate procedure over substance. The Second Department holds that not all violations of employment termination procedures are created equal—some are "material" and others are not. In *Delvecchio v. Bayside Chrysler Plymouth Jeep Eagle*, 271 A.D.2d 636, 637, 70 (2nd Dep't 2000), the plaintiff had a five-year contract to serve as a director of used car operations for several corporate defendants. The contract provided that he could be terminated for "cause" upon five days' written notice. The contract also had a "Bilateral Termination" provision, which allowed each party to terminate the contract without "cause," subject to the payment of \$250,000 of liquidated damages. The defendants terminated the plaintiff's employment without providing the requisite five days' written notice.

Relying on cases like *Scudder* (but not *Scudder* itself), the trial court held that the defendants' failure to follow the termination procedure rendered the "cause" termination ineffective, and awarded the plaintiff \$250,000 in liquidated damages.

The Second Department reversed. The court held that the "defendants' failure to provide written notice to the plaintiff did not, under the circumstances of this case, render the termination for cause ineffective....[T]hey did not forfeit their right to terminate the agreement for cause." The court explained that "notice was not a material term of the contract" because the "contract in this case did not afford the plaintiff an opportunity to cure and, for the most part, his alleged misfeasance was not, in any event, curable."

The existence of an opportunity to cure, however, is arguably insufficient to distinguish procedural violations that are "material" and "non-material" under *Delvecchio*. In *Scudder*, for example, the COO's contract did not provide an opportunity to cure, and his alleged disruptive "managerial style" was probably not curable in the eyes of management. Nonetheless, the COO prevailed because the company did not follow the contractual termination procedure.

The "materiality" standard does leave room to distinguish *Scudder* (where the employee prevailed because of the procedural breach) and *Delvecchio* (where the employee did not prevail despite a procedural breach). The due process protections afforded by written charges and an opportunity to respond were arguably "material" to the *Scudder* COO. If the

company followed the procedure, he would have had the opportunity to explain himself and persuade the board not to fire him—as unlikely as that result may have been.

By contrast, the five-days' notice procedure in *Delvecchio* was a formality. It could not change the result—other than by delaying the termination by five days. The maximum damages caused by violating the five-day notice provision was five days' salary (and any other employment benefits accruing during the five-day period). Thus, it is hard to see why the plaintiff-employee in *Delvecchio* should be entitled to further damages based on the company's violation of the notice procedure.

Strict Proceduralism

Notwithstanding *Delvecchio*, at least some New York case law suggests that the "materiality" of procedural breach is irrelevant. Judge Bernard Fried, formerly a prominent judge in the Commercial Division, wrote: "The law in New York for failure to follow employment termination procedures is clear. In particular, when an employer terminates an employee, whether the termination is 'for cause' or 'without cause,' the employee will prevail in a breach of contract claim if the termination does not comply with the termination procedures set forth in the contract." *Current Medical Directions v. Salomone*, 907 N.Y.S.2d 99 (Sup. Ct. 2010).

In *Salomone*, a CEO sold his company to investors and executed an employment agreement with the resulting company. His contract stated the company could terminate him for "cause" if the company's operating profit after taxes (OPAT) was less than 75% of the average

OPAT for the three previous years, based on audited financial statements prepared by the company's accountants. The company fired the CEO pursuant to this provision based on the 2005 OPAT, but failed to provide him the 2005 OPAT calculation. In fact, when he was fired, the company's auditors had not started the audit required to determine the 2005 OPAT.

The company argued that it did not breach the termination procedure because the "CEO was aware of the company's 2005 financial performance and was aware that in no event did 2005 OPAT equal or exceed 75% of the average of the preceding three years' OPAT." In other words, the company argued that, given the company's poor financial performance, calculation of the OPAT was a mere formality.

Judge Fried granted summary judgment to the CEO because the company "breached the Employment agreement by failing to comply with the termination procedures." Significantly, when Judge Fried made that ruling, the company was in the process of preparing the 2005 OPAT at the direction of the court. Thus, the company could have shown that "cause" did in fact exist to terminate the CEO—and the delay in providing the 2005 OPAT did not affect the outcome and was (at least arguably) "immaterial." But the court made clear that the CEO was nonetheless entitled to prevail.

Strategic Considerations

Given these competing authorities and principles, New York law affords judges significant discretion when applying employment termination procedures. If an employment contract provides for arbitration, which is common, the arbitrators will have even more discretion. Lawyers negotiating employment contracts can contract around the uncertainty by specifying consequences for procedural violations.

Company counsel should avoid unnecessary procedural formalities—especially ones that could keep a problematic employee in place. Company counsel should also be wary of procedures that require written allegations or explanations of "cause," which could force the company to admit its vicarious liability to a third party in writing. Meanwhile, employee-side counsel should be alert for procedural missteps by the company, which may have "dire consequences." *Hanson*, 218 A.D.2d at 911.

Curtis B. Leitner is a business litigation partner in McCarter & English's New York office. He represents companies and individuals in complex civil disputes, as well as white collar criminal and regulatory enforcement matters. He can be reached at cleitner@mccarter.com. **Trevor J. Larrubia** is an associate in the firm's Stamford, CT, office. He can be reached at tlarrubia@mccarter.com.