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Drafting Restrictive Covenant Agreements


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Introduction

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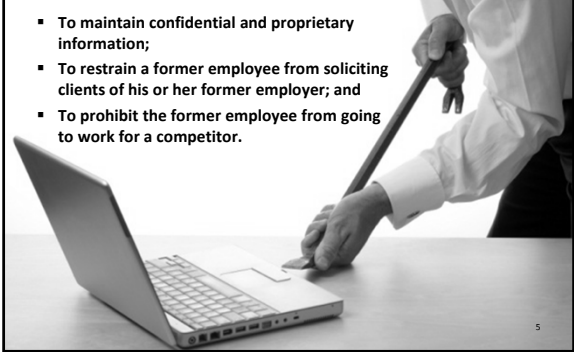
**Restrictive Covenants/
Non-Compete Agreements:**

**Commonly used in employment contracts to
prevent unfair competition.**



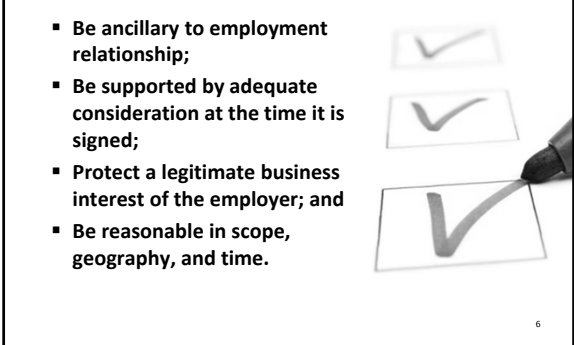
Purposes:


- To maintain confidential and proprietary information;
- To restrain a former employee from soliciting clients of his or her former employer; and
- To prohibit the former employee from going to work for a competitor.



**In order to be considered enforceable, a
restrictive covenant agreement must:**

- Be ancillary to employment relationship;
- Be supported by adequate consideration at the time it is signed;
- Protect a legitimate business interest of the employer; and
- Be reasonable in scope, geography, and time.





Topics to Be Discussed

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Topics to be discussed

- Ancillary to Employment Agreement
- Consideration
- Protection of Legitimate Business Interests
- Reasonableness
- Other Drafting Provisions



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Ancillary to Employment Agreement


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Ancillary to employment agreement

- Restrictive covenants **MUST** be ancillary to an employment contract. *Nat'l Bus. Services Inc. v. Wright*, 2 F.Supp.2d 701, 707 (E.D. Pa. 1998).
- Restrictive covenants entered into as part of the initial employment agreement are typically considered to be ancillary to the agreement, and therefore, valid and enforceable. *Capital Bakers, Inc. v. Townsend*, 231 A.2d 292, 293 (Pa. 1967).
- Restrictive covenants may still be ancillary to the employment relationship if executed subsequent to the taking of employment, where:
 - There was a change in employment status. *Maint. Specialties Inc. v. Gottus*, 314 A.2d 279 (Pa. 1974).
 - The employer offered regular employment rather than interim upon the condition that the employee signs a restrictive covenant. *Modern Laundry & Dry Cleaning Co. v. Farrer*, 536 A.2d 409, 411 (Pa. Super. 1988).
 - The question of whether a covenant is ancillary to the employment relationship is connected with whether there is adequate consideration. *Maint. Specialties Inc. v. Gottus*, 314 A.2d 279 (Pa. 1974).

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Consideration

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To be enforceable, a restrictive covenant must be supported by “adequate” consideration.

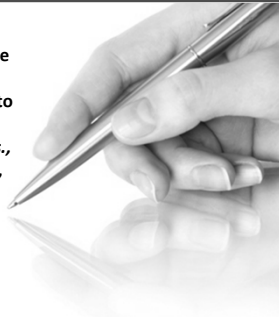
- **The adequacy of the consideration depends on factors such as:**
 - the employee’s position with the employer;
 - the employee’s level of relevant experience;
 - the employee’s level of relevant customer contact in prior employment; and
 - the extent of training that the employer provides to the employee.



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Consideration

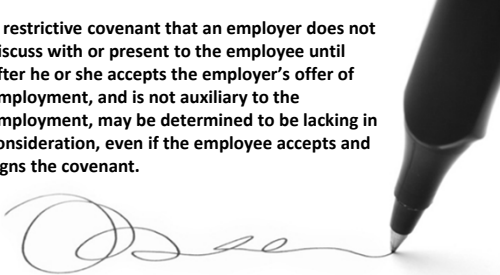
- A restrictive covenant that the employee accepts as part of the terms and conditions of the employee's hire is considered to be supported by adequate consideration. *Nat'l Bus. Servs., Inc. v. Wright*, 2 F.Supp.2d 701, 707-08 (E.D. Pa. 1998).



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Consideration

- A restrictive covenant that an employer does not discuss with or present to the employee until after he or she accepts the employer's offer of employment, and is not auxiliary to the employment, may be determined to be lacking in consideration, even if the employee accepts and signs the covenant.



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Consideration

- Under Pennsylvania law, *mere continued employment is inadequate to support a restrictive covenant that an employee enters into after accepting the employer's offer of employment.* *National Risk Mgmt., Inc. v. Bramwell*, 819 F.Supp. 417 (E.D. Pa. 1993).
 - If the employer provides no consideration, other than mere continued employment, to support a covenant entered into after the employee's initial acceptance of employment, the covenant is invalid due to a lack of consideration.
 - Under basic principles of contract law, once an employee accepts an employment offer that does not contain a restrictive covenant, an employer that wishes to impose a covenant on the employee must provide the employee with some *additional* consideration to support the covenant. *Davis & Warde, Inc. v. Tripodi*, 616 A.2d 1384 (Pa. Super. 1992); *Wincup Holdings, Inc. v. Hernandez*, 2004 WL 953400 (E.D. Pa. May 3, 2004).

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Sufficient consideration for restrictive covenants:

- \$2000 annual raise and change of employment status from at-will to contractual constituted sufficient consideration. *Insulation Corp. of Am. v. Brobston*, 667 A.2d 729, 733 (Pa. Super 1995).
- New job duties, cash payments, new severance package, and a guarantee of certain job benefits constituted sufficient consideration. *Davis & Warde v. Tripodi*, 616 A.2d 1387 (Pa. Super. 1992).
- Change in status from employee to independent contractor at employee's request constituted sufficient consideration. *Quaker City Engine Rebuilders, Inc. v. Toscana*, 369 Pa. Super. 573, 535 A.2d 1083 (Pa. Super. 1987).
- Promotion constituted sufficient consideration. *Records Center, Inc. v. Comprehensive Management, Inc.*, 525 A.2d 433 (Pa. Super. 1987); *American Homecare Supply Mid-Atlantic LLC v. Gannon*, 10 Pa. D. & C. 5th 362 (Lackawanna Co. 2009).

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Legitimate Employer Interests

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Legitimate Employer Interests



- Restrictive covenants will only be valid to the extent necessary to protect an employer's legitimate business interests.

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Legitimate Employer Interests

▪ **Interests include:**

- Trade secrets and confidential business information:
 - Protectable only to the extent they fulfill the general standard for protection set forth under Pennsylvania trade secret law, the Uniform Trade Secrets Act ("UTSA"), 12 Pa.C.S. § 5301 et seq., which defines a trade secrets as:
 - "Information, including a formula, drawing, pattern, compilation including a customer list, program, device, method, technique or process that:
 - Derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use.
 - Is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.

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Legitimate Employer Interests



▪ **Interests include:**

- Trade secrets and confidential business information:
 - Specialized training:
 - An employer may use a restrictive covenant to protect the investment it has made in providing specialized training in the methods of its business to an employee. *WellSpan Health v. Bayliss*, 869 A.2d 990 (Pa. Super. 2005).

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reasonable
unreasonable

Reasonableness

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Reasonableness

- The reasonableness of a restrictive covenant is relevant only in an action for an injunction to enforce the covenant. Reasonableness is not an issue in an action for damages for breach of a restrictive covenant. *Boyce v. Smith-Edwards-Dunlap Co.*, 580 A.2d 1382 (Pa. Super. 1990).
- The defendant (employee) has the burden of proving that the temporal and/or geographic scope of a restrictive covenant is unreasonable. *Jacobsen & Co., Inc. v. Int'l Env't Corp.*, 235 A.2d 612, 619 (1967).

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Reasonableness depends on whether the restrictive covenant is limited in time, geographic area, and scope-of-business.



- Restrictive covenant language must be specifically drafted to be reasonably necessary in a particular situation.

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Reasonableness depends on whether the restrictive covenant is limited in time, geographic area, and scope-of-business.

- **Geographic area:** limitations should not be broader than the area in which the employee is active, even if the employer's business spans a broader region. *Fres-Co Sys. USA, Inc. v. Bodell*, 2005 WL 3071755 at *5 (E.D. Pa. Nov. 15, 2005) (refusing to enforce restrictive covenant that extended beyond former employee's sales territory or industry).

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Reasonableness

- Pennsylvania is a "blue pencil" jurisdiction, meaning that courts have broad power to grant partial enforcement of a restrictive covenant, both by removing offensive terms and by adding limiting language, in order to grant an employer only that protection which it deems is necessary to protect legitimate interests. *American Homecare Supply Mid-Atlantic LLC v. Gannon*, 10 Pa. D. & C. 5th 362 (Lackawanna Co. 2009) (court reformed covenant to the extent necessary to protect the employer's legitimate business interests by lessening the radius of applicability of the covenant).

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Other Drafting Provisions

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Non-Solicitation of customers:

- **Prevents the employee from taking advantage of a prior relationship.**
 - A customer nonsolicitation covenant was reasonable as it pertained to a chiropractor when the covenant contained a two-year and 45-mile radius limitation. *Medical Wellness Assoc., P.C. v. Heithaus*, 51 Pa. D. & C. 4th 1 (Westmoreland Co. 2001).
 - A customer nonsolicitation clause is not per se unreasonable because it does not contain time and geographic limitations. The court can equitably modify the covenant to protect the employer's interests. *Plate Fabrication & Machining, Inc v. Beller*, 2006 WL 14515 (E.D. Pa. Jan. 3, 2006).
 - A customer nonsolicitation agreement will not be held as reasonable if it is overbroad in protecting the employer's legitimate business interests. See *American Homecare Supply Mid-Atlantic LLC v. Gannon*, 10 Pa. D. & C. 5th 362 (Lackawanna Co. 2009) (nonsolicitation clause was only valid as it pertained to the eight accounts with which employee had contact).

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Non-Solicitation of employees:

- **Prevents the former employee from contacting and soliciting existing employees to leave and go to a competitor. Generally, absent contractual restrictions, such efforts by the ex-employees are permissible, the only exceptions being systematic solicitations to cripple or destroy the company, or an integral part of that company, rather than to obtain the services of the employees, or to acquire the trade secrets of the employees.**
 - See *Clarke Transp. Servs., Inc. v. Haskins*, 2006 WL 1620175 (E.D. Pa. June 8, 2006) (company could not prove ex-employees solicited company's employees or other customers when there were many complaints of operational problems inside the company, which the court viewed as the real reason for the departure of the employees and customers).
 - See also *Fallabel v. Brophy-Walter*, 6 Pa. D. & C. 5th 129 (Carbon Co. 2008) (employer could not prove that employees that had allegedly left his employment to join his ex-employee's dental practice were currently employed by the ex-employee).

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Confidentiality Provision

- **Prevents the use and disclosure of confidential business information and trade secrets of the employer.**
 - The advantages of inclusion of a confidentiality provision in a noncompete agreement are two-fold: (1) the employer has contractual remedies for a breach; and (2) the employer can define what information is confidential. As a result, it can protect certain information that might not be protectable under the Uniform Trade Secrets Act mentioned above.

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Presumption of Irreparable Harm Provision

- **Provides that the parties are in agreement that a breach of the restrictions would result in irreparable harm to the employer.**
 - Courts are not bound by covenant provisions stating that the parties agree that a violation of the covenant would constitute irreparable harm and that the employer would be entitled to an injunction. *Dice v. Clinicorp, Inc.*, 887 F. Supp. 803, 810 (W.D. Pa. 1995).
 - However, the inclusion of such an irreparable harm clause does indicate the employee's awareness of the potential consequences of any breach and weighs into the balance of equities on a motion for injunctive relief. *Nat'l Bus. Servs. v. Wright*, 2 F. Supp. 2d 701, 709, n. 5 (E.D. Pa. 1998).

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Consent to Injunctive Relief Provision

- **Related provision in which the employee consents to injunctive relief in the event of a violation.**
 - A preliminary injunction, however, will only be granted if the following is proven: 1) a strong likelihood or success on the merits; 2) a showing of immediate and irreparable harm that cannot be compensated by money damages; 3) a showing that greater injury will result if preliminary injunctive relief is denied than if such relief is granted; and 4) a showing that a preliminary injunction would restore the status quo. *Allegheny Anesthesiology Assoc., Inc. v. Allegheny General Hosp.*, 826 A.2d 886 (Pa. Super. 2003).
 - Termination was not the exclusive remedy under a covenant not to compete because construction of the contract as such would violate the provision of the contract where the employee expressly consented to the imposition of injunctive relief against him so that the employer could enforce the restrictive covenant. *Plate Fabrication & Machining, Inc. v. Beiler*, 2006 WL 14515 (E.D. Pa. Jan. 3, 2006). 31

Liquidated Damages Provision

- **The specified damages must be reasonably related to a reasonable estimate of just compensation for actual damages.**
 - The prevailing party in a restrictive covenant case can obtain liquidated damages, including disgorgement of profits, if (1) the former employer includes such a clause in an employment contract and (2) the sum agreed to constitutes, at the time the parties enter into the underlying contract, a reasonable approximation of the expected loss rather than an unlawful penalty. *Perry v. H&R Block Enters., Inc.*, 2009 U.S. Dist. LEXIS 73759, at *9 (E.D. Pa. Aug. 18, 2009).
 - If the contract includes an election of remedies clause that indicates the party can seek either injunctive relief or obtain liquidated damages, if the party pursues injunctive relief and obtains the same, it will not be permitted to later seek liquidated damages. *Fishkin v. Susquehanna Partners, Inc.*, 2007 WL 560703 at *8 (E.D. Pa. Feb. 12, 2007). 32

Forfeiture provision

- **Requires that a party in violation of restrictions forfeits some benefit otherwise due. Can be enforced if not punitive in nature.**
 - In *Fraser v. Nationwide Mut. Ins. Co.*, 334 F.Supp. 2d 755 (E.D. Pa. 2004), the court held that a forfeiture of up to \$364,000.00 in deferred compensation by an independent insurance agent could be imposed if the agent entered into competition with his principal.
 - **NOTE:** A forfeiture for competition clause is also enforceable in Pennsylvania for lawyers. *Capozzi v. Latsha & Capozzi, P.C.*, 797 A.2d 314, 320 (Pa. Super. 2002). 33

Damage remedy

▪ **Alternative to seeking injunctive relief.**

- In contemplating such a provision, it should be considered whether damages would adequately protect the employer and, if so, include a provision in the agreement establishing a means of calculating such damages.
- An employee who damages an employer by competing against the employer in violation of a covenant not to compete is required to account for all profits earned as a result of competing against the employer and is liable to the employer for all damages proximately caused by the competition. The employer's damages most commonly are measured by determining the profits lost to the improper competition. *Hayes v. Altman*, 266 A.2d 269, 271-72 (Pa. 1970). The new employer's or former employee's gain or profits is generally not recoverable as damages for breach of the non-competition agreement. *American Air Filter Co. v. McNichol*, 527 F.2d 1297, 1299 (3d Cir. 1975).
- Compensatory and liquidated damages may be difficult to prove, as the case of *Fallabel v. Brophy-Walter*, 6 Pa. D. & C. 5th 129 (Carbon Co. 2008), suggests. If an employer cannot adequately prove the requested damages, the court will dismiss the employer's claims and hold for the employee.

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Choice of Law Provision

▪ **A choice of law provision should be included in every agreement. To increase the likelihood of enforcement, the venue selected should have a substantial relationship to the contract and the employment relationship.**

- Pennsylvania courts generally honor the intent of the contracting parties and enforce choice of law provisions in contracts executed by them. *Smith v. Commonwealth Nat'l Bank*, 557 A.2d 775 (Pa. Super. 1989).
- Courts in Pennsylvania will give effect to a choice of law provision in a restrictive covenant when the state law of which has been selected enjoys a substantial relationship to the parties or the transaction and the application of the law is not contrary to the public policy of another state with a stronger interest in the transaction. *Verizon Communications, Inc. v. Pizzirani*, 462 F. Supp. 2d 648, 655 (E.D. Pa. 2006).

▪ **Determine: which state laws could apply and which would provide the best protection for the client.**

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Choice of Venue Provision

▪ **In Pennsylvania, choice of venue provisions are generally upheld.**

- A forum selection clause is presumptively valid and will be enforced by the forum unless the party objecting to its enforcement establishes that: 1) it is the result of fraud or overreaching; 2) enforcement would violate a strong public policy of the forum; or 3) enforcement would in the particular circumstances of the case result in litigation in a jurisdiction so seriously inconvenient as to be unreasonable. *Igames Entm't, Inc. v. Regan*, 2004 WL 2538285 (E.D. Pa. Nov. 9, 2004).
- Courts will generally enforce a forum selection clause in the employment context where the contract was executed while the employee still had a choice to enter into the employment relationship. *Barbuto v. Medicine Shoppe Int'l, Inc.*, 166 F. Supp. 2d 341, 346-7 (W.D. Pa. 2001).

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Attorneys' Fees Provision

- In *Cardiac Consultants, P.C. v. Feinberg*, 70 Pa. D. & C. 4th 536, 588 (Lancaster Co. 2004), the trial court awarded attorney's fees to a successful defendant who had opposed the entry of an injunction to enforce a restrictive covenant. The restrictive covenant contained a clause that awarded attorney's fees to the prevailing party.
- An attorney's fee provision in a noncompete clause is not enforceable in equity under Pennsylvania law, where the covenant as judicially reformed in equity was not breached. *Mrozek v. Eiter*, 805 A.2d 535, 539-40 (Pa. Super. 2002).

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Severability Clause

- Ensures that the striking of one provision does not result in a determination that the entire agreement is unenforceable.
 - The court applied the doctrine of severability to permit a two-year, 25-mile radius restriction over an ex-Arthur Murray dance instructor. *Niedland v. Shrenk*, 6 Pa. D. & C. 2d 176 (Phila. Co. 1955).



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Compulsory Arbitration Provision:

- There is a strong presumption in favor of arbitration where the parties to a contract have specifically provided for arbitration of their disputes. *Specialty Bakeries, Inc. v. RobHal, Inc.*, 961 F.Supp. 822, 827 (E.D. Pa. 1997). The court upheld an arbitration provision in the case of *Clark v. Weber, Gallagher, Simpson, Stapleton, Fires & Newby*, 2006 WL 2988181 (Phila. Co. Oct. 17, 2006).

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Return of Records Provision



- Requires employees to return all employer records and property upon resignation or termination. This provision should identify what documents and records are company property.

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Assignment Provision

- Pennsylvania case law provides that covenants not to compete are not typically assignable to new employers once a business entity has been sold, unless the employment contract specifically provides for assignment. *All-Pak, Inc. v. Johnston*, 694 A.2d 347, 351 (Pa. Super. 1997). After an assignment, the employer seeking to enforce a restrictive covenant as an assignee under Pennsylvania law must comply with all terms of the assignment. *Savage, Sharkey, Reiser & Szulborski Eye Care Consultants, P.C. v. Tanner*, 848 A.2d 150 (Pa. Super. 2004).

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Assignment Provision (continued)

- **NOTE:** The Pennsylvania Supreme Court has held that a restrictive covenant not to compete, contained in an employment agreement, is not assignable to a purchasing business entity, in the absence of a specific assignability provision where the covenant is included in a sale of assets. See *Hess v. Gebhard & Co., Inc.*, 808 A.2d 912 (Pa. 2002). However, subsequent decisions in the Third Circuit and the Pennsylvania Superior Court have limited this distinction to sale of assets only and not stock purchases or sale of membership interests in an LLC. In the instance of a stock purchase or sale of membership interests, the assignability provision is not material in determining whether the purchasing entity can enforce the restrictive covenant. *J.C. Ehrlich Co., Inc. v. Martin*, 979 A.2d 862 (Pa. Super. 2009); *American Homecare Supply Mid-Atlantic LLC v. Gannon*, 10 Pa. D. & C. 5th 362 (Lackawanna Co. 2009); *Zambelli Fireworks Mfg. Co., Inc. v. Wood*, 592 F.3d 412 (3d Cir. 2010); *Missett v. Hub Int'l Pennsylvania, LLC*, 6 A.3d 530 (Pa. Super. 2010).

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