PROGRAM MATERIALS
Program #31222
October 5,2021

Over-reaching Provisions That Could Jeopardize Your Noncompetition Covenants

- **Paul Rooney, Esq. -** Ellenoff Grossman & Schole LLP

Celesq® AttorneysEd Center
www.celesq.com

5255 North Federal Highway, Suite 100, Boca Raton, FL 33487
Phone 561-241-1919

OVER-REACHING PROVISIONS THAT COULD JEOPARDIZE YOUR NONCOMPETITION COVENANTS

By: Paul P. Rooney, Esq.

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OVER-REACHING PROVISIONS THAT COULD JEOPARDIZE YOUR NONCOMPETITION COVENANTS

I. The Purpose of this Course.

The inspiration for this course was a serious of matters encountered by me and my colleagues involving provisions of covenants not to compete that none of us had seen before.

We concluded that attorneys would benefit from a course that not only addressed the specific provisions we had encountered, but also provided a framework – a sort of recipe book – for attorneys to use when they encounter other non-competition provisions that attorneys devise in the future.

Attendees of this course will be provided with authority (both for and against) potentially over-reaching covenants not to compete that they may find in employment agreements, and legal materials that will assist in formulating arguments with regard to any provision of a non-competition provision that is novel that address whether they constitute a form of over-reach that should (or perhaps should not) either result in invalidation of the covenant not to compete itself, or, at the least, a declaration that the particular enforcement provision is unenforceable.

II. Types of Non-Competition Agreements.

There are three main types of agreements that restrict competition:

- Covenant Not To Compete: An agreement to refrain from working for a competitive business, generally in a specific geographic area, for a certain amount of time after employment ends.
    - Example: A hairdresser agrees not to work at another salon within ten miles of her employer for one year after the hairdresser's employment ends.
- Covenant Not to Solicit: An agreement not to solicit customers (and sometimes employees) for a certain period of time after employment ends.

  - Example: The same hairdresser mentioned above agrees not to solicit any customers of the salon where the hairdresser works for one year after her employment ends.

- Confidentiality Agreement: An agreement to keep an employer's confidential information secret after employment ends. Sometimes such agreements are perpetual.

  - Example: A salon has a secret formula for hair styling gel that the hairdresser agrees to keep confidential.

While this course is primarily concerned with covenants not to compete, the other types of agreements will also be mentioned.

III. How the Law Disfavors Covenants Not To Compete.

The most important fact about covenants not to compete is that they are disfavored by the law. Normally, barring a statute prohibiting the object of a contract, a person in the U.S. can contract to do most anything on any terms that they like. They can sell their home for a peppercorn.

By contrast, a business may not enter into a contract prohibiting a former employee from competing or from soliciting its employees or customers just because it wants to do so. That is because in this country the law favors open competition which includes employee mobility. The law also recognizes that the individual employee has an important interest in being permitted to earn a living.

To that end, while there have long been many states that had statutes that restricted covenants not to compete with regard to specific professions, such as medicine and law, and only one state, California, expressly barred them by statute, there are now over 30 states that have statutes that regulate covenants not to compete generally. *See* Chart attached as Annex "1" to this presentation.

Moreover, In addition to state legislatures, the federal executive branch has taken an interest in the issue. Lamenting that "[p]owerful companies require workers to sign non-compete agreements that restrict their ability to change jobs" President Biden issued an executive order requiring federal agencies to adopt "pro-competitive regulations." *See* "Executive Order on Promoting Competition in the American Economy" (July 9, 2021). In that regard, the order encourages the Federal Trade Commission "to exercise the FTC's statutory rulemaking authority . . . to curtail the unfair use of non-compete clauses and other clauses or agreements that may unfairly limit worker mobility."

Regardless of whatever statutory rules a state may impose, in every state where they are allowed, a business may enter into a covenant not to compete only if it has a legitimate business interest to protect. The law recognizes essentially three legitimate business interests: a) protection of good will from being unfairly expropriated by a former employee; b) protection of confidential information; and c) the rarely, if ever invoked, protection from competition from employees whose services are unique or extraordinary.

Moreover, a business may not use a covenant not to compete to provide absolute protection to its good will and confidential information. Rather, the law requires that the restrictions placed upon the employee by a covenant not to compete be "reasonable." What is "reasonable?" In general it is the level of restriction that is no greater than the restrictions necessary to protect the aforementioned "legitimate business interest."

The attributes of the covenant not to compete that must be reasonable include: a) its duration; b) its geographic scope; and c) the scope of activities it prohibits (for example, a computer salesperson might be prohibited from working as a salesperson for a competitor, but not be prohibited from plowing its driveways). Unreasonable provisions can be declared unenforceable.

In its seminal case on this subject, the New York Court of Appeals succinctly summed up these standards as follows:

> The modern, prevailing common-law standard of reasonableness for employee agreements not to compete applies a three-pronged test. A restraint is reasonable only if it: (1) is *no greater* than is required for the protection of the *legitimate interest* of the employer, (2) does not impose undue hardship on the employee, and (3) is not injurious to the public. A violation of any prong renders the covenant invalid.
>
> In general, we have strictly applied the rule to limit enforcement of broad restraints on competition. Thus . . we [have] limited the cognizable employer interests under the first prong of the common-law rule to the protection against misappropriation of the employer's trade secrets or of confidential customer lists, or protection from competition by a former employee whose services are unique or extraordinary.

BDO Seidman v. Hirshberg, 93 N.Y.2d 382, 388–89, 712 N.E.2d 1220, 1223 (1999) (emphasis in original) (internal citations omitted); *see also Int'l Bus. Machs. Corp. v. Lima,* 833 F. App'x 911, 912 (2d Cir. 2021) (summary order) ("A restrictive covenant between an employer and employee will only be subject to specific enforcement to the extent that it is reasonable in time and area, necessary to protect the employer's legitimate interests, not harmful to the general public and not unreasonably burdensome to the employee") (internal quotation marks omitted).

A unique aspect of covenants not to compete, however, is that courts have the power to "blue pencil" agreements that are unreasonable. "Blue Penciling" refers to courts reducing the terms of unreasonable provisions to terms that are reasonable. For example, a two-year duration might be reduced to one year; a geographic scope covering all of New York state might be reduced to a certain set of counties.

This blue-penciling power, however, comes with a caveat – that if a provision is so unreasonable that a court concludes that an employer included it not for the purpose of enforcing it, but for an *in terrorem* effect upon the employees (and their would-be employers) to deter hiring of the employee. Again, in *BDO Seidman*, the New York Court of Appeals succinctly stated the concern that hangs over all covenants not to compete – that the employer will simply go too far:

> The issue of whether a court should cure the unreasonable aspect of an overbroad employee restrictive covenant through the means of partial enforcement or severance has been the subject of some debate among courts and commentators (*see*, Blake, *op. cit.*, at 682–683). **A legitimate consideration against the exercise of this power is the fear that employers will use their superior bargaining position to impose unreasonable anti-competitive restrictions, uninhibited by the risk that a court will void the entire agreement, leaving the employee free of any restraint** (*id.*). The prevailing, modern view rejects a per se rule that invalidates entirely any overbroad employee agreement not to compete. Instead, when, as here, the unenforceable portion is not an essential part of the agreed exchange, a court should conduct a case specific analysis, focusing on the conduct of the employer in imposing the terms of the agreement (*see, Restatement (Second of Contracts* § 184). Under this approach, **if the employer demonstrates an absence of overreaching, coercive use of dominant bargaining power, or other anti-competitive misconduct**, but has in good faith sought to protect a legitimate business interest, consistent with reasonable standards of fair dealing, partial enforcement may be justified.

BDO Seidman, 93 N.Y.2d at 394, 690 N.Y.S.2d at 860-61.

That concern is always in the background of any consideration of whether a provision is reasonable. It is especially important when a provision is novel. Any court faced with a novel provision cannot but wonder – Why is this included? What is so special about this employer and this employee that this provision is necessary?

In short, it is a reasonable assumption that novel provisions will be met with the suspicion that it was included not for any legitimate purpose, but to unfairly deter hiring of the employee by planting in the employee's and the employee's potential employers' minds the idea that these unreasonable provisions will actually be enforced.

IV. <u>Equity and the Balancing of The Employer's Legitimate Interests v. Open Competition and Employee Interests.</u>

In addition to these consideration, it must be borne in mind that whether to enforce a covenant not to compete is fundamentally a ***matter of equity*** and a balancing of considerations.

Specifically, "[i]n determining whether a restrictive covenant is reasonable, courts must balance the employer's legitimate business concerns with New York's strong public policy against causing a person to lose the ability to earn a livelihood." *Mercer Health & Benefits LLC v. DiGregorio*, 307 F. Supp. 3d 326, 349 (S.D.N.Y. 2018).

The most commonly invoked important equitable consideration is whether the covenant not to compete imposed "undue hardship" upon the employee.

Under the principles discussed above, Courts can, however, examine the totality of the circumstances in deciding whether to enforce a covenant not to compete on the basis of what it believes is equitable. In other words, whether it is "fair" to do so. A court that sees provisions in a covenant not to compete that suggest the employer is overreaching – abusing its power – is not likely to enforce it.

V. <u>Provisions That May Jeopardize Non-Competition Agreements.</u>

A. <u>Liquidated Damages Provision.</u>

Not uncommonly, covenants not to compete have provisions for liquidated damages to be paid in the event they are breached. They make sense because of the difficulty in proving damages that result from a breach of a non-competition covenant.

At least one court, however, in Delaware, a state whose law is often chosen to govern the terms of employment of corporate executives whose companies are incorporated there, suggested that liquidated damages clauses in noncompetition agreements are inherently suspect.

In *Lyons Ins. Agency, Inc. v. Wark*, No. CV 2017-0348-SG, 2020 WL 429114, at *1 (Del. Ch. Jan. 28, 2020), the Delaware Chancery Court, wrote:

> Liquidated damages clauses in contractual non-competes **<u>are particularly suspect</u>** as potentially unreasonable restraints on competition, and on ex-employees' interests in earning a living. This Court may enforce such clauses, but only where

> they reasonably relate to an actual anticipated loss caused by the employee's anti-contractual competition.

Id. at *2 (emphasis added).

In the case, the employer sought to impose liquidated damages upon a former employee of 1 ½ times the amount of her book of business that went to her new employer regardless of whether she had any role in the transfer. The court held that "here the liquidated damages are untethered to Lyons' interest in preventing loss due to ex-employee competition, and the liquidated damages provision is unenforceable. . ." *Id.* Accordingly, the court found that the liquidated damages provision was "unreasonable to the extent it purport[ed] to impose fixed damages untethered from any act or behavior ... beyond that of choosing to work for a competitor." *Wark*, 2020 WL 429114, at *7-8.

Because the employer sought only to enforce the liquidated damages clause (presumably because they were no longer in a position to obtain an injunction) and the court invalidated the liquidated damages clause, the employer ended up with no remedy. The court awarded summary judgment to the employee.

There are other examples of similar reasoning employed by Delaware courts.

In *Faw, Casson & Co., L.L.P. v. Halpen*, 2001 WL 985104, at *3 (Del. Super. Ct. Aug. 7, 2001), which the *Wark* court relied upon, the Delaware Superior Court declined to apply the liquidated damages clause at issue which imposed damages of 100% of the fees paid by former clients that became clients of the employee's new accounting firm to situations where the employee had no role in the clients leaving his former employer. The court ruled that a liquidated damages provision that is simply a contractual penalty untethered to losses caused by ex-employee competition serves effectively as an *in terrorem* clause, and was an unreasonable and unenforceable limitation on the ex-employee. *Id.* at *3.

Similarly, in *Tropical Nursing, Inc. v. Arbors at New Castle Subacute & Rehab. Ctr.*, 2005 WL 8135148, at *6 (Del. Super. Ct. Apr. 4, 2005) the Delaware Superior Court found a liquidated damages clause to be a penalty where the provision sought to disincentivize the defendant from "hiring away" an employee from plaintiff where there was no evidence "hiring away" had any bearing on the parties' business relationship.

TAKEAWAY: Because the liquidated damages clause was used for purposes of deterring a violation of a covenant not to compete, the court applied extra scrutiny to the question of whether the conduct the employer sought to deter had a legitimate basis – reasonable restriction of competition to prevent loss to the employer. When faced with such a clause, the employee-litigant should use that extra scrutiny to place an even heavier burden upon the employer than it usually bears in justifying a covenant not to compete.

B. One-sided Attorney Fee-Shifting Provisions.

Anecdotally, another increasingly common provision is the one-sided attorney fee-shifting provision; that is, a clause stating that while the employer will be able to recover its fees if it prevails in a dispute over a covenant not to compete, the employee cannot. What could be more intimidating to an employee seeking to test the enforceability of a covenant not to compete than the prospect of paying the employer's fees but being unable to collect their own fees?

Most courts have held that one-sided attorneys' fee provisions in contracts, including those involving covenants not to compete, are enforceable. For example, in *Kelly Services, Inc. v. De Steno*, Case No. 18-118 (6th Cir. Jan. 10, 2019), fees were granted for "enforcing" a covenant not to compete where the employee agreed as follows: "I further agree to pay any and all legal fees, including without limitation, all attorneys' fees, court costs, and any other related fees and/or costs incurred by the Company in enforcing this Agreement." Notably, the clause did not even require the employer to prevail in its enforcement efforts in order to win fees!

What can an employee faced with this type of clause argue in the face of it?

1. **Statutes Governing Fee-Shifting Clauses.**

First, the employee should look to the applicable state law to see if it governs one-sided attorney fee-shifting clauses.

Notably, at least seven states have statutes that automatically make one-sided attorney fee shifting clauses reciprocal. CAL. CIV. CODE § 1717; FLA. STAT. ANN. § 57.105(7) (West 2006 & Supp. 2012); HAW. REV. STAT. § 607-14 (1993 & Supp. 2007); MONT. CODE ANN. § 28-3-704 (2011); OR. REV. STAT. ANN. § 20.096 (West 2003 & Supp. 2012); UTAH CODE ANN. § 78B-5-826; WASH. REV. CODE. ANN. § 4.84.330 (West 2006 & Supp. 2012). *See, e.g.*, FLA. STAT. ANN. § 57.105(7); OR. REV. STAT. ANN. § 20.096. For example, a Montana statute provides as follows:

> **28-3-704. Contractual right to attorney fees treated as reciprocal -- exception.** (1) Except as provided in subsection (2), whenever, by virtue of the provisions of any contract or obligation in the nature of a contract made and entered into at any time after July 1, 1971, one party to the contract or obligation has an express right to recover attorney fees from any other party to the contract or obligation in the event the party having that right brings an action upon the contract or obligation, then in any action on the contract or obligation all parties to the contract or obligation are considered to have the same right to recover attorney fees and the prevailing party in any action, whether by virtue of the express contractual right or by virtue of this section, is entitled to recover reasonable attorney fees from the losing party or parties.

MONT. CODE ANN. § 28-3-704 (2011)

Moreover, some courts have taken it upon themselves to make attorney fee-shifting clauses reciprocal. *See Cf. Otis Elevator Co. v. W.G. Yates & Sons Constr. Co.*, No. 5:12-CV-1708-KOB, 2016 WL 826731, at *13 (N.D. Ala. Mar. 3, 2016) (where plaintiff argued that the contract only permitted it to recover attorney's fees, and the contract contained conflicting provisions, the court construed it to allow either party to recover fees if it prevails; noting "[t]o hold any differently would be an unconscionable result").

Accordingly, in those states with statutes, or courts hostile to such agreements, a one-sided attorney fee provision simply will not have its intended effect. In fact, to the extent an employer hoped to be able to intimidate an employee the provision will have armed the employee with the ability to shift his or her fees to the employer.

2. <u>Arguments that One-Sided Fee-Shifting Should Invalidate A Covenant Not To Compete or that One-Sided Fee-Shifting Should Not Apply To A Dispute Involving a Covenant Not to Compete.</u>

Even in states where there are no such statutes, however, courts may use their equitable powers to police noncompetition provisions over "reasonableness" to refuse to enforce such provisions or even refuse to enforce the contract altogether. Just as courts will throw out and refuse to enforce (without blue-penciling) overly broad and vague noncompetition agreements on the grounds that they are bad faith efforts to deter employees from exercising their rights to compete, courts could apply the same reasoning to one-sided fee-shifting provisions. *See Flatiron Health, Inc. v. Carson*, 19 Civ. 8999 (VM), 2020 U.S. Dist. LEXIS 48699 (S.D.N.Y. March 20, 2020) (refusing to enforce or blue pencil overbroad and vague noncompetition covenant).

Research did not disclose any cases where a court decided not to enforce a covenant not to compete because it included a one-sided attorney fee-shifting provision. Courts have, however, declined to enforce one-sided attorney fee-shifting provisions in covenant not to compete cases.

In *Sysdyne Corp. v. Rousslang*, No. 27-CV-10-27691, 2013 WL 10229736, at *5–6 (Minn.Dist.Ct. Mar. 18, 2013), the Plaintiff employer prevailed on its claim that the defendant employee had breached a covenant not to compete. The employer moved for an award of attorneys' fees pursuant to the following clause in the agreement:

> ***Remedies.*** Employee acknowledges and agrees that the confidential information, trade secrets and special knowledge to be acquired by he or she during his or her employment with the Company is valuable and unique and that breach by Employee of the provisions of this Agreement may cause the Company irreparable injury and damage which cannot be reasonably or adequately compensated by damages. *Employee, therefore, expressly agrees that the Company shall be entitled to injunctive or other equitable relief in order to prevent a breach of this Agreement or any part thereof, in addition to damages, costs and* reasonable attorney's fees, *and such other remedies legally available to the Company*. The Employee further authorizes the Company to notify all customers and potential customers of this Agreement, and may provide a copy of this Agreement to any such person or company.

(Emphasis added in decision.)

In response, the employee argued that "this provision does not entitle Sysdyne to recover attorney fees unless those fees are incurred in seeking 'injunctive or other equitable relief in order to prevent a breach of th[e] Agreement.'" The court concluded that the text was "ambiguous on the issue of whether Sysdyne has a contractual right to recover attorney fees incurred in seeking damages for a breach of the Employment Agreement — in other words, for fees that were not incurred in seeking injunctive relief or "to *prevent* a breach" of the Employment Agreement." The court decided to "construe[ ] this ambiguity in favor of [the employee]" for three reasons, including "the unilateral nature of the attorney fee provision." The court reasoned that:

> As drafted, the Employment Agreement does not afford Rousslang any right to recover attorney fees. That right belongs solely to Sysdyne. Contract provisions for unilateral fee shifting that inure solely to the benefit of the drafting party should be strictly construed in favor of the non-drafting party. Just as Sysdyne had the power to include a fee-shifting provision that inures solely to its benefit, Sysdyne had the power to draft a fee-shifting provision that clearly provides for the recovery of fees incurred in an action seeking damages for breach of contract.
>
> For those reasons, the Court construes the Employment Agreement as not providing Sysdyne with a contractual right to recover attorney fees incurred in an action seeking damages for breach of contract. Sysdyne's motion for attorney fees is thus denied.

Sysdyne Corp. v. Rousslang, No. 27-CV-10-27691, 2013 WL 10229736, at *5–6 (Minn.Dist.Ct. Mar. 18, 2013).

As support for this ruling, the Court cited a California case for this proposition: "It is common knowledge that parties with superior bargaining power, especially in 'adhesion' type contracts, customarily include attorney fee clauses for their own benefit. This places the other contracting party at a distinct disadvantage. Should he lose in litigation, he must pay legal expenses of both sides and even if he wins, he must bear his own attorney's fees. One-sided attorney's fees clauses can thus be used as instruments of oppression to force settlements of dubious or unmeritorious claims. Section 1717 [the California statute making one-side fee-shifting provisions reciprocal] was obviously designed to remedy this evil." (internal citations omitted). Sysdyne Corp., 2013 WL 10229736, at *6 (Minn.Dist.Ct. Mar. 18, 2013) (quoting, 19 Cal. App. 3d 581, 596-97, 97 Cal. Rptr. 30, 39 (Ct. App. 1971)

There is no shortage of cases where courts have held that one-sided attorneys' fees provisions have gone unenforced by courts that have described them as "oppressive" or worse. *Shukla v. Sharma*, 586 F. App'x 752, 754 (2d Cir. 2014) (one-sided fee-shifting provision was unenforceable; noting that New York courts consider such provisions "to be fundamentally unfair and unreasonable"); *In re Checking Account Overdraft Litig*. MDL No.2036, 485 F. App'x 403, 406 (11th Cir. 2012) (finding one-sided fee-shifting provision to be oppressive and unconscionable under North Carolina law); *Perez v. DirecTV Grp. Holdings, LLC*, 251 F. Supp. 3d 1329 (C.D. Cal. 2017) (noting that California courts "deem unconscionable one-sided fee-shifting provisions in favor of the drafter of a contract of adhesion"). *Herzog Aluminum, Inc. v. Gen. Am. Window Corp.*, 39 Wash. App. 188, 196, 692 P.2d 867, 872 (1984) (recognizing the "oppressive use of one-sided attorney's fees provisions").

For example, the case of *In re Checking Account Overdraft Litigation*, 813 F.Supp.2d 1365, 1375 (S.D. Fla. 2010) involved a one-sided fee-shifting contract clause in the Bank Services Agreement of SunTrust Bank. The agreement contained a fee-shifting clause entitling the prevailing party to attorneys' fees from the loser. But the clause was unilateral inasmuch as it provided that SunTrust could withdraw the attorneys' fees directly from the account holder's checking account if SunTrust was the prevailing party. *Id.* The U.S. District Court for the Southern District of Florida found that this clause was substantively unconscionable because although the fee-shifting provision was mutual, the disparity between each party's *ability to collect* an award of fees was one-sided and not mutual. *Id.* at 1374-75.

On the other hand, there are cases where courts have allowed one-sided attorney fee-shifting clauses to be enforced, including in cases where an employer was enforcing a covenant not to compete. *Ryan v. The Ridge at Back Brook, LLC*, No. HNT-L-447-13, 2016 WL 11220955, at *6 (N.J.Super.L. May 16, 2016) ("New Jersey courts enforce contractual attorneys' fee provisions even where such provisions are unilateral and run in favor of one party alone") (citing *Alcoa Edgewater Federal Credit Union v. Carroll,* 44 N.J. 442 (1965); *Cmty. Realty Mgmt. v. Harris*, 155 N.J. 212 (1998).

In *McGowan & Co. v. Bogan*, 93 F. Supp. 3d 624, 642–43 (S.D. Tex. 2015) a Texas federal court applying Ohio law ruled that a one-sided attorney fee-shifting provision was enforceable in case where an employer sued to enforce a covenant not to compete.

While acknowledging that "until recently Ohio courts and the Sixth Circuit applying Ohio law precluded contractual recovery of attorneys' fees unless the attorneys' fees provision was specifically negotiated" the court held that "the Sixth Circuit abrogated this line of cases." *Id.* (citing *Allied Indus. Scrap, Inc. v. OmniSource Corp.*, 776 F.3d 452 (6th Cir.2015), *abrogating*

Scotts Co. v. Cent. Garden & Pet Co., 403 F.3d 781 (6th Cir.2005). The Court wrote, "[i]n *Allied Industrial Scrap*, the Sixth Circuit held that unilateral or one-sided fee shifting provisions, such as the one at issue here, are generally enforceable under Ohio law, based on *Wilborn v. Bank One Corp.*, 121 Ohio St.3d 546, 906 N.E.2d 396 (2009), a case in which the Ohio Supreme Court upheld a one-sided, fee-shifting provision in a bank's contract for a home equity loan. *Id.* at 453. In *Wilborn*, the Ohio Supreme Court reasoned that absent any evidence of unconscionability, duress, or public policy to the contrary, "agreements to pay another's attorney fees are generally 'enforceable and not void as against public policy so long as the fees awarded are fair, just and reasonable as determined by the trial court upon full consideration of all of the circumstances of the case.'" *Wilborn*, 906 N.E.2d at 400–01 (quoting *Nottingdale Homeowners' Ass'n, Inc. v. Darby*, 33 Ohio St.3d 32, 514 N.E.2d 702, 702 (1987) (syllabus)). Thus, the court held that "should Plaintiff prevail at trial on its breach of contract claim, Plaintiff would be entitled . . . to recover fair, just, and reasonable attorneys' fees."

TAKEAWAY: Many courts recognize one-sided attorney fee-shifting provisions as inherently "oppressive" and unreasonable. They are probably one of the most effective provisions for deterring employees and their would-be employers from even challenging covenants not to compete because the potential liability is unlimited and could be far out-of-proportion to the economic benefit the employee might receive from a new job. Accordingly, it is not hard to imagine a court applying its equitable powers to not only refuse to enforce such a provision in regard to a covenant not to compete, but to invalidate the covenant not to compete itself as:

a) being abused as an instrument of *in terrorem* intimidation of employees including those whose rights are being violated; and b) therefore the entire agreement cannot be reasonably severed from the balance of the agreement. That being said, there is just as much authority sustaining one-sided attorney fee provisions, including in cases involving covenants not to compete.

C. Provisions Allowing Employer To Unilaterally Stop Payments.

Also likely to draw scrutiny are provisions that promise an employee that they will be paid for the duration of the noncompetition agreement, but give the employer the option not to pay the employee (or stop paying the employee) if it decides at some point not to enforce the noncompetition agreement. This puts the employee in the unenviable position of not being able to assure an employer that he or she can work for them when they leave, while not being assured of an income during the noncompete period, and being at risk of having their income cutoff on short notice without the opportunity to line up another job.

Such provisions give the illusion of "reasonableness" and should not be assessed differently, in terms of the burden imposed on the employee, than noncompetition provisions that offer no payment during the noncompetition period. While an argument can be asserted that it should not matter that the employer can discontinue the payments because, in theory, the employer could impose a noncompetition provision with no pay during the period, there is an "iron fist inside a velvet glove" element, to such provisions that makes them coercive.

1. Massachusetts Approach to Unilaterally Discontinuing Payments.

Notable in this regard is the Massachusetts Noncompetition Agreement Act, which requires "garden leave" payments of 50% of base compensation or other mutually-agreed consideration to be paid during the noncompetition period. In order to satisfy that provision of the act, the agreement must "except in the event of a breach by the employee, not permit an employer to unilaterally discontinue or otherwise fail or refuse to make the payments." Mass. General Laws c.149 § 24L(b)(vii).

The implication of this provision of the statute is clear – that severance benefit that can be taken away at the employer's whim is worthless – maybe less than worthless. Just as the California statute on reciprocal attorneys' fees and its rhetoric influenced a Minnesota court to invalidate and not enforce a one-side fee-shifting provision, this common sense provision of the Massachusetts statute could influence courts to police noncompetition agreements in a similar fashion so that they do not unreasonably restrict freedom of competition.

2. **<u>Argument that Provision For Unilateral Cessation of Severance Payments Are Unenforceable Under New York Law.</u>**

New York law also espouses principles in employment cases that would, if applied to this context, lend themselves to an argument for invalidating a covenant not to compete that includes a one-sided attorney fee-shifting clause. Under a long line of cases dating to the 1930s, New York has refused to place an employee "at the mercy" of his or her employer by permitting an employer to require an employee to work for the employer for a term of years or be sued for breach of contract if he or she quits without cause, while on the other hand reserving to itself the right to discharge the employee at will.

Under *Carter v. Bradlee*, 245 A.D. 49, 50, 280 N.Y.S. 368, 370 (1st Dep't 1935), *aff'd*, 269 N.Y. 664, 200 N.E. 48 (1936), an employee who is employed under a contract for a term of years may not be discharged without cause even if the contract also contains a clause allowing the employer to discharge the employee at will. The decision is based on the principle that a contract should not be interpreted to place one party at the mercy of another.

In *Carte*r, the employee was employed under a contract which said, "This Agreement is made for two years from November 1, 1925, but it is understood and agreed that we retain the right to terminate the Agreement and to discharge you at any time, should we feel called upon to do so for any reason." *Id.*, 245 A.D. at 50. The trial court, on the basis of this language, dismissed the employee's complaint on the grounds that the employer employed the employee at will. The Appellate Division reversed the trial court's decision and held that, "[i]t is contended by the defendants that the trial justice properly decided that under the foregoing provision the plaintiff could be discharged at any time. We adopt a different view. Such a construction would make the contract merely one at the defendants' will, though by its terms it was for two years. A construction will not be given to a contract, if possible, that would place one of the parties at the mercy of the other." *Id.*

More recently, the Second Circuit reversed a district court's order granting summary judgment dismissing an employee's claim for breach of contract where the contract contained both a definite term and provision allowing immediate termination without cause and without severance pay. *Leninger v. Gibbs & Hill, Inc*., 730 F.2d 903, 904 (2d Cir. 1984). The employee had a contract to work in Taiwan "for a two-year period." Under the heading "Termination" the contract had a subparagraph entitled "For Cause of Resignation" that set forth in detail the "causes" which would justify termination. *Id.* A separate subparagraph entitled "Completion of Work" read in pertinent part as follows: "G & H [the employer] may terminate this agreement and your employment hereunder at any time for . . . G & H's convenience or in the event that, in . . . G & H's judgment, the work for which you were hired or assigned under this agreement has been completed, indefinitely suspended or terminated." *Id.* at 903-04. The Second Circuit rejected the employer's argument that this clause gave it "the unrestricted right to discharge appellant at any time it chose, with or without reason to do so." Id. at 904. The court explained:

> In interpreting contracts, New York courts understandably seek constructions that fairly and equitably impose mutuality of obligation, rather than interpretations that place one of the parties at the mercy of the other. [citations omitted] In applying this canon of construction to an employment contract, one New York court aptly stated, "if this employment contract is to be read as one terminable at will, it may just as well never have been written."

Id. (quoting *Vogel v. Pathe Exchange, Inc.*, 234 A.D. 313, 254 N.Y.S. 181 (1932)). The Court concluded that "If the contract in the instant case was to be terminable at the unfettered discretion of appellee, it made no sense for appellee to set forth in subparagraph A of paragraph 17 the numerous grounds warranting a discharge for cause. [citation omitted] Moreover, it would be deceptive or, at best, meaningless to include a clause permitting termination at will in a subparagraph headed 'Completion of Work.'" *Leninger*, 730 F.2d at 904-05 (citing *Yazujian v. J. Rich Steers, Inc.*, 195 Misc. 694, 701, 89 N.Y.S.2s 551 (1949)).

Since then, the New York Courts have decided several cases which state that an employer may terminate a contract for a definite term of employment without cause *only so long as* the contract contains a provision for payment of severance or a penalty to the employee should the employer exercise the right to terminate the contract without cause. The Southern District of New York has stated the rule as follows:

> Unless the parties provide otherwise . . . a contract of employment for a definite term may not be lawfully terminated by the employer, prior to the expiration date in the absence of just cause. [citations omitted] In such a case, the discharge of an employee without cause before the term of his contract constitutes a breach of the contract by the employer.
>
> The parties can, however, contract expressly to provide the employer with the ability to terminate the contract without cause prior to the expiration of the term, as long as the employee's relinquishment of this legal protection is supported by consideration such as a severance package.

Leiser v. Gerard Daniel & Co., 2002 WL 1285558, at *10 (S.D.N.Y. June 11, 2002) (emphasis added).

In *Leiser*, the employee was employed for a specified term, but his contract also provided that "certain severance benefits will be payable 'if at any time the Employee is discharged by the Company for reasons other than' disability or cause." *Id.* (quoting employment contract) (emphasis supplied by the court). Accordingly the court granted summary judgment to the employer on the employee's breach of contract claim asserting that the employer had no right to terminate him without cause. *Id.*

The *Leiser* court relied upon the First Department's decision in *Berzin v. W.P. Carey & Co., Inc.*, 740 N.Y.S.2d 63, 64 (1st Dep't 2002) which affirmed an employer's motion to dismiss a breach of contract claim brought by a terminated employee whose contract for a term of years provided that he would be paid severance if the employer terminated him without cause. The employee had entered into a series of employment agreements. The one in effect at the time of the employee's discharge "gave the Company the right to terminate [the employee] without cause in which case he would be entitled to severance payments . . ." On appeal, the employee argued that the termination of the agreement violated the covenant of good faith and fair dealing. The court rejected this argument, holding that "[t]he covenant of good faith and fair dealing cannot negate defendant's express right to terminate the revised agreement without cause at any time notwithstanding its fixed term." *Berzin*, 740 N.Y.S.2d at 64.

Likewise, in *Rothenberg v. Lincoln Farm Camp, Inc.*, 755 F.2d 1017, 1021 (2d Cir. 1985), the Second Circuit reaffirmed that a termination without cause is permissible in a contract binding the employee to a definite term where, "the contract provide(s) unequivocally that the employer [can] terminate the contract without cause but [is] thereupon obligated to pay a penalty to the employee." *Id.* at 1021.

Also, an earlier Second Circuit case, acknowledged that *Carter v. Bradlee* remained good law, but stated that it did not apply when the employment contract that contained both a term for years and termination without cause provision provided for a payment to the employee upon termination. *Olsen v. Arabian American Oil Co.*, 194 F.2d 477, 479 (2d Cir. 1952). Accordingly, the court affirmed the district court's dismissal of the employee's complaint. The contract provided that the employee would serve as a pilot in Saudi Arabia for thirty months but further stated that the company could terminate the employment without cause "upon payment of minimum return transportation and travel expense, salary for normal travel time to place of recruitment and upon payment of a sum equivalent to a minimum of four weeks' basic salary." *Id.* at 478. The court held that the employer's termination of the employee was not a breach of contract, citing prior Second Circuit and New York state cases that "upheld the employer's option to terminate [a] contract [for a term of years] at any time upon payment of the specified penalty." Id. The court further explained that "[t]he contract in the case of *Carter v. Bradlee* . . . is distinguishable in that there the employer's option could be exercised without any penalty payment and the contract would have lacked mutuality had the court not read into the agreement that requirements that the discharge before good cause alone." *Id.* at 479.

TAKEAWAY: *Carter v. Bradlee* and its progeny stand for the principle that "New York courts understandably seek constructions that fairly and equitably impose mutuality of obligation, rather than interpretations that place one of the parties at the mercy of the other." A court that embraces that principle and an expansive view of its equitable powers, has plenty of leeway to rule that a contract entitling an employer to unilaterally cease making a severance payment places one of the parties at the mercy of the other and is, therefore, unenforceable.

3. Counter-Argument Under New York Law.

Carter v. Bradlee was affirmed by the New York Court of Appeals and that affirmance has never been reversed or overruled. Nevertheless, one lower New York court has declined to continue to apply it. *Perry v. New York Law School,* No. 2003-600064, 2007 WL 9662154, at *3 (N.Y. Sup. Ct. July 02, 2007).

In *Perry,* the court wrote, “There is older authority that a contract provision permitting termination without cause during the term of a contract for a definite duration will not be enforceable unless the contract provides for a penalty to be paid upon the termination. *Id.* (citing *Rothenberg v Lincoln Farm Camp, Inc*., 755 F.2d 1017 (2d Cir 1985) (purporting to summarize New York law); *Leiser*, 2002 WL 1285558; *Olsen v Arbian Am. Oil Co*., 194 F2d 477 (2d Cir 1952); and *Reiss, supra*). The court further wrote, “The rationale of these cases is that the contract would have lacked mutuality absent a requirement that the employer pay a penalty for the exercise of the option to terminate the contract without cause before the expiration of the term.” Similarly, *Carter v Bradlee, [supra]* refused to enforce a provision in a contract for a definite term permitting termination at will during the term. The court reasoned that enforcement of the at will provision ‘would make the contract merely one at the defendants' will’ (that is, one lacking in mutuality) and therefore that discharge before the expiration of the term should have some reasonable ground and be made in ‘good faith.’ *Perry*, 2007 WL 9662154, at *3 (internal citations omitted).

Finally, the *Perry* court wrote, “This court holds that these authorities are not good law in light of the more recent Appellate Division holding in *Berzin v W.P. Carey & Co., Inc*, (293 A.D.2d 320, *supra)* permitting enforcement of a provision for termination at will in a contract for a definite duration. These authorities are also inconsistent with *Murphy v American Home Prods. (*58 N.Y.2d 293, *supra)* which reaffirmed the New York rule that a contract for at-will employment permits termination for any reason or no reason, and that an obligation of good faith and fair dealing on the part of the employer is therefore inconsistent with and will not be implied in such a contract.” *Perry*, at 2007 WL 9662154, at *3.

D. <u>Requirements to Disclose Future Intellectual Property Creation.</u>

Another creative and potentially oppressive provision is a requirement that a former employee disclose to their former employer all intellectual property they create in the follow one or two years.

The employer's justification for this provision is to provide protection for its confidential information by informing the employer if its confidential information and trade secrets are being used by another business. That is certainly a "legitimate business interest." Employers can be expected to argue that it is a species of confidentiality agreement in the sense that all it does is protect confidential information and intellectual property.

In substance, however, such provisions are covenants not to compete in disguise that are in reality much broader than express covenants not to compete. First, the reality is that any employer hiring an employee to create intellectual property will undoubtedly have its own intellectual property that it wants to keep confidential. Accordingly, any such would-be employee subject to such a clause is effectively unemployable in their field for the duration of the clause; in effect the employee is subject to a covenant not to compete.

Moreover, at least a covenant not to compete is enforceable only when the employee goes to work for an employer that is a competitor of his former employer. These clauses would apply to any employer, regardless of whether it is a competitor of the business seeking to enforce the agreement. As such, it is more burdensome upon the employee's employment prospects than a typical covenant not to compete.

Such clauses should be treated as, and analyzed under the law as, covenants not to compete and rise or fall on the basis of such principles.

E. <u>Covenants that Apply to "Low-Wage" Workers.</u>

Another innovation of recent years has been the imposition of covenants not to compete upon more categories of employees, including in one notorious case, the sandwich makers at Jimmy John's. This has now drawn the attention of state legislatures. At the rate of current developments, covenants not to compete that apply to low-wage employees will be barred in many states.

In recent years, Colorado, Illinois, Maryland, New Hampshire, Rhode Island, and Virginia have passed laws forbidding the imposition of covenants not to compete upon low wage or non-exempt (hourly-paid) employees.

For example, Illinois Freedom to Work Act, 820 ILCS 90/1, provides that "No employer shall enter into a covenant not to compete with any low-wage employee of the employer" and that a "covenant not to compete entered into between an employer and a low-wage employee is illegal and void." *Id.* § 10(a) and (b). The act defines a covenant not to compete as an agreement. "Covenant not to compete" means an agreement:

> (1) between an employer and a low-wage employee that restricts such low-wage employee from performing:
>
> > (A) any work for another employer for a specified period of time;
> >
> > (B) any work in a specified geographical area; or
> >
> > (C) work for another employer that is similar to such low-wage employee's work for the employer included as a party to the agreement . . .

The Act defines "low-wage employee" as "an employee whose earnings do not exceed the greater of (1) the hourly rate equal to the minimum wage required by the applicable federal, state, or local minimum wage law or (2) $13.00 per hour." *Id.* § 5.

The Illinois Act covers a relatively narrow range of employees who are making minimum wage or close to it.

Colorado's statute, however, forbids covenants not to compete to be imposed upon all non-exempt employees, a much broader category. The Colorado statute, Colorado Revised Statutes ("C.R.S.") § 8-2-113(2), provides that: "Any covenant not to compete which restricts the right of any person to receive compensation for performance of skilled or unskilled labor for any employer shall be void, but this subsection . . . shall not apply to: . . .Executive and management personnel and officers and employees who constitute professional staff to executive and management personnel."

TAKEAWAY: Increasing numbers of states are limiting the ability of employers to impose covenants not to compete upon low wage or non-exempt employees. Accordingly, before imposing covenants on non-exempt employees, employers should check laws of any states whose laws may apply to the agreement to see if a statute forbids it and employees facing litigation should do the same, bearing in mind that it may not always be the state where the employee works or the law of the state provided for in the relevant agreement's choice of law clause.

CONCLUSION

As some of the cases discussed above show, due to the lack of controlling authority concerning novel features of covenants not to compete, there is opportunity to drawn upon the broad general principles courts have set forth in this area of the law, case law from different states and even principles enshrined in statutes of different states to craft arguments to challenge (or sustain) such covenants. Our hope is that this program will give you a head start if you encounter such agreements in your practice.

ADDENDUM 1
STATES WITH STATUTES REGULATING
NON-COMPETITION AGREEMENTS

The following U.S. jurisdictions states now have statutes that ban or regulation covenants not to compete:

Arkansas	Missouri
California	Montana
D.C.	Nevada
Colorado	New Hampshire
Florida	North Dakota
Georgia	Ohio
Hawaii	Pennsylvania*
Louisiana.	Rhode Island
Illinois	South Dakot
Maine	Texas
Maryland	Utah
Massachusetts	Vermont
Michigan	

*Pennsylvania has legislation pending.

ADDENDUM 2:
CHECKLIST FOR COVENANT NOT TO COMPETE CLIENT

The following checklist is for use in an interview with a client (employer or employee) who has a dispute concerning a covenant not to compete.

I. What Agreements Exist Between Employer and Employee and do they contain non-competition agreements?

Type of Agreement	Non-Competition Provisions
Employment Agreement?	________________________
IP Assignment and NDA	________________________
Option or Equity Grant Agreement?	________________________
Equity Plan?	________________________
Shareholder Agreement?	________________________
Limited Liability Company Agreement?	________________________
Director Compensation Agreement?	________________________
Corporate Bylaws?	________________________
Partnership or L.P. Agreement?	________________________

II. Do the agreements containing covenants not to compete contain any of the following?

Type of Provision	Yes or No
Liquidated Damages Provision	________________________
One-Sided Fee-Shifting Provision	________________________
Unilateral Right to Stop Severance pay	________________________
Requirement to Disclose Future IP Development	________________________
Applies to non-exempt Employees	________________________

III. What Law Applies?

Do agreements contain choice of law clauses? ____________________________

Where does the employee lives? ____________________________

Where does the employee work? ____________________________

Where is the employer incorporated? ____________________________

Do agreements contain choice of venue clauses? ____________________________

Which possible states have most favorable law? ____________________________

IV. What are the attributes of the covenant?

What is the covenant's duration? ____________________________

What activities does it prohibit? ____________________________

What is its geographic scope? ____________________________

What other protections does the employer have? (i.e., non-solicit; confidentiality) ____________________________

V. Employee

Employee's Title and Duties ____________________________

Exempt of Non-exempt? ____________________________

Salary/Wage ____________________________

Access to confidential information? ____________________________

Direct access to customers? ____________________________

Reason Employment Ended ____________________________

New Employer ____________________________

New Position and Duties ____________________________