This newsletter explores important considerations for companies and some uncommon approaches to protecting your company’s competitive advantage, customers, confidential information and employees from unfair competition and poaching.

Decades of experience and knowledge of the uneven statutory and common law of the 50 states teaches that a company’s defenses to unfair competition must include a coordinated system of protection to be effective. Some states are friendly to efforts to protect competitive advantage, some are unforgiving and some are downright impossible. But whether you are in the best of states or the worst of states, there are some measures that every company should consider keeping in its arsenal to protect its competitive edge.

“Bad Boy” and “claw back” restrictive covenants in executive compensation and ERISA severance plans can be an important component of an employer’s overall protection of its business from unfair competition.

Restrictive covenants, such as non-competition agreements, are prohibited or disfavored under the law of many states. Employers who wish to limit competition by employees or former employees may, however, be able to circumvent these state laws by adopting an ERISA-governed plan that incorporates a so-called “bad boy” clause, or certain state law-governed plans that offer employees a choice between competing and accepting the compensation offered under the plan.

“Bad boy” clauses are contract provisions that solicit employees or misappropriate confidential information. A corresponding “claw back” provision enables the employer to recover compensation already paid to the current or former employee.

ERISA covered plans

Whether benefits may be subject to forfeiture and claw back depend on whether the forfeiture relates to a so-called “qualified plan.” Vested benefits in a qualified plan — such as, for example, a 401(k) plan or a defined benefit pension plan — cannot be forfeited due to the employee’s competition.

Top-hat plans

Conversely, top-hat plans are “unfunded,” non-qualified ERISA plans used primarily to provide deferred compensation to a select group of management or highly
compensated employees. They are not subject to ERISA's vesting requirements. Consequently, a top-hat plan participant who violates a bad boy provision can forfeit even plan benefits described as “vested,” so long as the plan allows a forfeiture in that situation. ERISA governs suits to recover top-hat plan benefits, and preempts state law — including state law that prohibits or disfavors restrictive covenants and non-competition agreements.

Participants who are denied benefits because they violated a bad boy clause will usually have to exhaust the plan's administrative remedies and seek a determination by the plan administrator — most often, the employer or a committee appointed by the employer — before going to court to challenge the restrictions. If the plan is properly drafted, the courts should give considerable deference to the plan administrator's decision.

### Severance pay plans

Properly drafted and administered, severance pay plans may qualify as ERISA-governed employee welfare benefit plans. The advantage to the employer of the severance plan being treated as a welfare benefit plan is that, generally, benefits under a welfare benefit plan do not “vest,” and the plan sponsor can reserve the right to terminate and/or amend the plan. Therefore, the employer can change the terms of severance plan before the event that would trigger entitlement to the benefits — such as the termination from employment. And, the severance plan may include a bad boy clause that is conditioned on honoring the restrictive covenants.

Employers should consult with counsel when considering adopting an ERISA-governed severance pay plans. Among other things, the plan should provide:

- A specific class of potential beneficiaries to be covered by the severance plan;
- Specific conditions for payment of benefits (for example, a layoff of employees in a situation such as a plant closure, or reduction in force);
- Discretionary authority on the part of the plan administrator to determine eligibility for benefits under the terms of the plan, and;
- Specific continuing benefits consisting of more than a lump sum payment (for example, payment of one-quarter of the severance benefits upon termination, and the balance over a two year period).

### Plans Governed by State Law

ERISA does not apply to many types of executive compensation programs, such as stock option and restricted stock plans, because most such plans fall outside of the definitions of ERISA-covered retirement and welfare benefit plans. However, even in those plans, restrictions on competition generally enjoy broader enforceability than other restrictive covenants under most states' law because they are often viewed as falling under the “employee choice” doctrine. That is, the employee has a choice — compete or accept the benefit. As one court explained, there is a distinction between provisions that prevent employees from working for a competitor, and provisions that allow benefits to be forfeited if they do so. In other words, withholding the carrot (the compensation) may be appropriate, but attempting to apply the stick (an order preventing post-termination competition) may not be.

### Conclusion

Depending on the state law that governs, non-competition agreements and other restrictive covenants in the employment setting can be difficult, if not impossible, to enforce. ERISA-governed plans, and certain plans governed by state law that offer employees a clear choice between competing (and foregoing compensation) and accepting compensation without competing, can be a more effective and enforceable alternative.
Social Networking and Restrictive Covenants — Some Tips for Employers

By Lawrence J. Del Rossi

Social networking websites function as a modern day Rolodex. Not only do these networks allow users to store all sorts of information about themselves, they also allow users to publicly “connect” to each other, which in turn enables them to view other members’ information, which can include photos, current job information, resume, work history, education, contact information and a list of that member’s other connections.

While many employers, particularly those involved in sales, are increasingly encouraging their employees to use these sites for advertising and marketing purposes, the perils and pitfalls in the context of restrictive covenants are obvious. They allow professionals of all kinds – salesmen, brokers, and agents, to name a few – to develop and maintain vast business and social relationships with great ease and little financial cost. For employers, who often devote significant resources to establishing long-lasting customer relationships and maintaining the confidentiality of their customers, a rogue employee’s use of these social networking devices can be a recipe for disaster, particularly when it relates to monitoring and enforcing restrictive covenants.

Although online social networking has been around for almost a decade, very few American courts have addressed whether a former employee has violated a restrictive covenant based on the employee’s social networking activities. See, e.g., Coface Collections North America Inc. v. Newton, 430 Fed. Appx. 162, (3rd Cir. 2011) (former owner of company, who among other things used LinkedIn account to compete with his former company, likely violated restrictive covenant; affirming district court’s entry of preliminary injunction); Sasqua Group, Inc. v. Courtney, 2010 WL 3613855 (E.D.N.Y Aug. 2, 2010) (denying TRO application, in part, based on defendant’s position that her employer’s contact list was not confidential or proprietary because clients had their contact information on Bloomberg, LinkedIn, Facebook and other publicly available databases); see also Hays Specialist Recruitment Ltd. v. Ions, et al., [2008] EWHC 745 (addressing situation where recruitment consultant used LinkedIn to start a competing recruiting agency)

Below are a few tips and other practical considerations for employers to consider in the context of social networking sites and restrictive covenants.

Tip 1: Advise employees that disclosure of confidential information on social networking sites is prohibited.

If client information is confidential, advise employees that identifying clients or having them as contacts on a social networking account could constitute a breach of the employee’s confidentiality obligations or duty of loyalty to the company.

Most jurisdictions require that for client data to be protectable, the employer must take reasonable steps to protect it. An employer may undermine any argument that its non-compete or non-solicitation clause is reasonable to protect the company’s legitimate business interests if the employer has encouraged or facilitated its employees’ use of social networking activities without taking adequate steps to monitor or control these activities as they pertain to its clients or customer data.

At an exit interview or in connection with an employee’s separation with the company, consider inquiring about the employee’s social networking activities as they relate to his or her employment. Ask employees whether any client or customer information exists on their social networking account(s). If it does, request that this information be removed immediately.

Tip 2: Take immediate steps to preserve evidence.

Information maintained by employees on social networking sites can be valuable evidence of an employee’s violation of a restrictive covenant. In Kelly Services v. Marzullo, 591 F. Supp. 2d 924 (E.D. Mich. 2008), for example, the court considered the job information listed on an employee’s LinkedIn profile as evidence that a former employee was violating his agreement not to compete with, or solicit the customers of, his former employer.

If an employer learns of an employee’s social networking activity that it believes violates a non-solicitation or other restrictive covenant, consider sending a cease and desist notice, including a specific request for the removal of any and all offending information. Most social networking sites allow users to restrict access to other users or immediately remove information. In addition,
consider putting the new employer on notice as the former employee may have used the new employer’s resources to post or communicate with clients and/or customers. Also, consider putting the website on notice (like the employer did in the Hays/Ions case discussed above), so that relevant data is not surreptitiously deleted.

**Tip 3: Analogize social networking activities to more traditional forms of communication**

A court will likely draw parallels between social networking activities and more traditional forms of communication like the telephone, letters or email. In *Total Care Physicians v. O’Hara*, (Del. Super. Ct. 2002), for example, the court concluded that a physician violated his non-solicitation agreement by sending patients a letter notifying them that he had moved to a new practice and touting his new practice’s capabilities and services. If mailing a letter or emailing a customer would constitute unlawful solicitation in a particular jurisdiction, then updating a profile or electronically alerting the customer through a social network should constitute unlawful solicitation as well. The medium through which an employee chooses to unlawfully solicit should not make a difference. Indeed, the employer’s chances of getting immediate injunctive relief, and of proving irreparable harm, may be easier to establish when a former employee uses a social network to solicit customers because of the employee’s ability to reach such large numbers people so quickly.

**Physician Restrictive Covenants — A Delicate Balancing Act**

By Mark E. Furlane and Lawrence J. Del Rossi

Restrictive covenants in contracts with physicians are generally governed by state common or statutory law. Except for those states where restrictive covenants are either legislatively or judicially prohibited, the states’ differing treatment of physician restrictive covenants generally revolves around the tension between a medical practice’s right to protect its patient relationships, goodwill and investment in training and mentoring, and a patient’s right to select a physician of his or her choice and the physician’s right to select a course of treatment and the location of this treatment (such as a particular hospital or medical facility) in the best interest of his or her patients.

Those states that prohibit physician practice restrictions (the minority view), such as Tennessee, Colorado, Delaware, and Massachusetts, generally find persuasive the American Medical Association Council on Ethical and Judicial Affairs, Op. E-9.02 (1998), which provides:

> “Covenants-not-to-compete restrict competition, disrupt continuity of care, and potentially deprive the public of medical services. The Council of Ethical and Judicial Affairs discourages any agreement which restricts the right of a physician to practice medicine for a specified period of time or in a specified area upon termination of an employment, partnership, or corporate agreement. Restrictive covenants are unethical if they are excessive in geographic scope or duration in the circumstances presented, or if they fail to make reasonable accommodation of patients’ choice of physician.”


A middle ground can be seen in Ohio, where its courts have explained:

“The AMA has stated that these agreements should be discouraged. It is vital that the health and expectations of patients, who are rarely aware of private agreements among physicians, be adequately protected. It is also important that competition among physicians be encouraged in these times of increasing health care costs.

Hence, in analyzing such covenants, a court must first be mindful of the rule of strict construction. These covenants should be strictly construed in favor of professional mobility and access to medical care and facilities. An adjunct to this principle of strict construction is that a court may modify the covenant between the parties under Raimonde to render it reasonable.”


Many states’ courts treat this tension between a patient’s and an employer’s rights as a balancing factor in considering whether to issue an injunction, and have generally approached the issue much in the same way a Pennsylvania court did in 2009:

“Where a covenant not to compete ‘seeks to limit the professional practice of a physician,’ courts must evaluate the covenant’s effect, if any, on the public interest. In the context of noncompete agreements amongst physicians, our Supreme Court has defined the public interest as a function of the availability of appropriate medical service to the community should an injunction be imposed.”

Thus, if a community has a dearth of physicians, a court will be less likely to issue an injunction preventing a physician from serving patients in the community. However, the fact that a court might not enjoin the physician from practicing in an area does not mean that same court will not allow an action for damages to proceed against the physician for breach of the restrictive covenant. See, e.g., Community Hosp. Group v. More, 869 A.2d 884 (N.J. 2005).

A state’s law and the opinions of its courts where the employer and physician do business should be consulted to determine the treatment of physician restrictive covenant enforcement.

The Benefits of Delaware
By Todd C. Schiltz and Joseph C. Schoell

Many companies include a provision in their employment agreements specifying that any dispute arising out of the agreement, including disputes regarding the enforcement of restrictive covenants, will be litigated exclusively in Delaware courts. Such a clause, generally referred to as a forum selection clause, is presumptively valid and will be enforced unless the party opposing enforcement shows that the clause is unreasonable, unjust or was procured by fraud. Additional expense or inconvenience do not demonstrate unreasonableness.

Including a clause designating Delaware as the exclusive forum for litigation has significant advantages. First and foremost, such a clause provides access to Delaware’s courts, including the Delaware Court of Chancery, in circumstances where an injunction is sought. Business groups, including the United States Chamber of Commerce, routinely rank the Delaware court system as the best in the nation. Disputes before the Court of Chancery are resolved by knowledgeable judges, not juries, who have expertise in business disputes and explain the reasons for their decisions in written opinions. The Court of Chancery also resolves disputes expeditiously. It is not unusual in the restrictive covenant context for injunctive hearings to be scheduled days after suit is filed and for a final hearing to be held within three or four months thereafter. Given the benefits of litigating in Delaware, we strongly recommend considering an exclusive forum selection clause designating Delaware as the forum of choice in your employment agreements.

In addition to forum selection clauses, many companies choose Delaware law as the law that will govern any disputes arising out of an employment agreement, including those regarding restrictive covenants. Where a contract involves aggregate consideration of $100,000 or more, a Delaware statute (6 Del. C. § 2708) provides that a provisions in a contract designating Delaware law as the law governing the contract will be enforced, provided that the parties to the agreement are subject to the jurisdiction of Delaware courts. Therefore, where the consideration for a non-compete provision exceeds $100,000, the courts of Delaware will rely on Delaware law to interpret and construe the contract, even if the contract and relationship between the parties is centered in a different jurisdiction. However, where the aggregate consideration
is less than $100,000, courts will apply a common law test to determine whether a choice of Delaware law in a contract should be honored. In that circumstance, a court reviewing a contract with a Delaware choice of law provision will enforce the provision and apply Delaware law only if Delaware has a material connection to the employer/employee relationship. Materiality exists if a party’s principal place of business is located in Delaware, a majority of the activity underlying the dispute occurs in Delaware, or where parties to the employment contract performed most of their services in Delaware. If Delaware does not have a material connection to the employer/employee relationship, we recommend including a Delaware forum selection clause but designating a state other than Delaware under a choice of law provision.

Companies select Delaware law because (a) Delaware is an at-will state and its courts recognize that restrictive covenants are necessary to prevent competitors from poaching employees and their valuable know-how; (b) Delaware courts recognize the freedom of contract and tend to enforce restrictive covenants as written (subject to reasonableness as to scope and duration); and (c) Delaware has a well-established body of case law detailing what is reasonable with regard to scope and duration of restrictive covenants and generally will reform, rather than strike down in total, provisions found to be unreasonable. Thus, while other states, such as California, eliminate or significantly limit an employer’s right to enforce restrictive covenants, Delaware recognizes their utility and generally upholds their terms when reasonable.

Reliable Fire Equipment Company v. Arredondo — The Enforceability of Noncompetition Agreements Requires Illinois Courts to Review the Totality of the Facts and Circumstances to Determine the Reasonableness of those Agreements

By Kenneth K. Dort and Jeremiah Posedel

After surveying 100 years of Illinois case law relating to restrictive covenants, the Illinois Supreme Court in Reliable Fire Equipment Company v. Arredondo, 2011 IL 111871, clarified the analysis when assessing the enforceability of such agreements. The Court first made clear that, in Illinois, employee agreements not to compete will be upheld only if they are “reasonable.” When determining the “reasonableness” of a noncompetition agreement, Illinois courts must analyze whether (1) the covenant is no greater than is required to protect the legitimate business interest of the employer; (2) no undue hardship is imposed on the employee; and (3) there is any injury to the public.

The key to this analysis lies in the Court’s focus on the first element of this test — the legitimate business interest of the employer — and the need to review this element in light of the totality of circumstances of the facts giving rise to the case. The Court noted that this analysis is and remains “unstructured,” and clarified that there is no particular test or universe of factors to be used in determining what constitutes a “legitimate business interest.” Instead, the various factors considered in prior case law “are only nonconclusive aids in determining the [employer’s] legitimate business interest, which in turn is but one component in the three-prong rule of reason, grounded in the totality of the circumstances.”

In Reliable Fire, the circuit court’s analysis (which was upheld by the appellate court) was deemed by the Supreme Court as “rigid and preclusive” as to the determination of the employer’s legitimate business interests. Based on the Supreme Court’s decision, the circuit court should have looked to the “totality of the facts and circumstances” per the above-noted three-prong test to determine the reasonableness and enforceability of the agreements at issue. Thus, the Supreme Court reversed both the circuit court and the appellate court findings that the underlying restrictive covenants were enforceable, and remanded the case back to the circuit court for additional proceedings consistent with its decision.

As a result, the new approach creates a level of uncertainty going forward in the absence of case law applying it to actual fact patterns. It is therefore highly recommended that companies utilizing noncompetition agreements review all of them immediately in light of Reliable Fire to assess their enforceability going forward.
The Fired Employee’s Non-Compete Agreement

By David J. Woolf and Mark E. Furlane

So you have fired an employee, and he (and perhaps his new employer) assume that he is now freed from the non-competition provision in his employment agreement. But is that correct? On one hand, how can an employer, with one fell swoop, keep an individual from working for both it and a competitor? On the other, a deal’s a deal, and the employee already received his portion of the deal (a job). The answer, like many matters involving restrictive covenants, is highly state specific and driven by the full set of facts involved.

Starting with the easiest end of the spectrum, there are some states that simply will not enforce a non-compete where there has been an involuntary termination without cause. New York is perhaps the most well-known example, with one court recently capturing the sentiment as follows: “Enforcing a noncompetition provision when the employee has been discharged without cause would be ‘unconscionable’ because it would destroy the mutuality of obligation on which a covenant not to compete is based.”

Most states, however, give an involuntary termination less than determinative effect, although to varying degrees. Pennsylvania, by itself, illustrates the range of impact an involuntary termination can have. In a 1995 decision, the Pennsylvania Superior Court held that an employer who fires an employee for poor performance effectively deems the employee to be “worthless” and therefore, in most circumstances, cannot be heard to argue that the employee should not be permitted to compete against it. (How could a “worthless” employee possibly give rise to the need to restrict competition, the argument goes.)

In September 2010, however, the same court held that the circumstances of termination are but one of many factors to be considered by the court and that the issue of enforceability is to be determined on a case-by-case basis.

Still other courts, absent evidence that the employer breached an employment agreement with the employee or acted in bad faith, can seem relatively unconcerned about the fact that it was the employer, rather than the employee, who severed the employment relationship. In one case before the Indiana Court of Appeals, the former employee, a doctor, argued that the fact that he was terminated without cause “creates … an issue concerning the reasonableness of the covenant.” The Court, citing the at-will employment doctrine and its respect for and belief in “individual freedom to contract,” disagreed and had no trouble enforcing the non-competition provision at issue.

So what should an employer who, arguably, wants to have his cake and eat it too do? First, think about the issue in the drafting stage and make sure that your agreement expressly provides that the restrictions apply whether the employee is terminated voluntarily or involuntarily and regardless of the reason. Leaving such language out can give a court an easy reason to deny enforcement.

Second, check applicable law. In virtually every state, involuntarily terminating the employee will, at least to some degree, compromise enforceability. The question will be the size of the disadvantage and the weight the court gives to it.

Third, if you are at the termination stage and your agreement provides for enforcement, consider paying the employee during some or all of the restriction period, potentially through a separation or consulting agreement (which would also allow the employee to re-affirm the underlying non-compete agreement).

Fourth, if paying the employee is not of interest or viable, give a hard look to both the reasons for termination and other circumstances at play. For example, in most states, the following factors will mitigate the impact of the termination: it was a high-level and/or long-term employee, the termination was for reasons unrelated to ability or everyday job performance (e.g., attendance, misconduct), and/or the employee held and used significant confidential information. On the other hand, where the employee was relatively low-level, employed for only a short term, worked hard but was a poor performer, and/or did not hold confidential information, your chances for success will likely be more limited.

Lastly, do not underestimate the fact that, unlike other areas of the law, non-competes largely remain creatures of equity, and judges therefore typically have significant discretion to fashion a “fair” remedy — whatever they might deem that to be. Some judges, for a variety of reasons, may simply believe that it would be unfair to enforce the non-compete under the circumstances. You will therefore want to explore your potential pool of judges and select your venue carefully.
Competitive Advantage, Trade Secret and Computer Fraud and Abuse Team

If you have any questions about, or would like assistance with, any of the matters discussed in this Newsletter, please contact any member of our Competitive Advantage, Trade Secret and Computer Fraud and Abuse Team listed below.

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