

AUGUST 2011 NEWSLETTER

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## ENFORCEMENT OF RESTRICTIVE COVENANTS IN EMPLOYMENT AGREEMENTS

**Before addressing this topic, the attorneys of Pozzuolo Rodden, PC are pleased to announce that they will be teaching Fall 2011 Continuing Legal Education seminars for attorneys (CLE) and Continuing Professional Education seminars for certified public accountants (CPE) this fall at Penn State University. More information is provided on page 5 and 6 of this Newsletter.**

### **Introduction**

Restrictive covenants in employment contracts are vital tools that enable employers to protect their trade secrets and customer base after an employee has been terminated or resigns. A restrictive covenant is a section contained in an employment agreement in which the employee agrees to refrain from doing a particular activity. In the employment setting this is common when an employee enters into a non-compete or non-disclosure agreement with his or her employer. A non-compete clause restricts an employee from accepting subsequent employment with a competitor of his employer, while a non-disclosure clause requires an employee to refrain from disclosing the trade secrets and confidential information of its employer after termination. However, restrictive covenants in employment agreements must be carefully drafted and narrowly tailored to be enforced by courts.

## **I. The History of Restrictive Covenants**

When the American judicial system was first developed it was based on existing English common law. In accordance with earlier English common law, restrictive covenants were automatically null and void because they severely limited an individual's right to earn a livelihood in his profession. However, once industrialism spread the employer's interest in protecting their trade secrets and customer's information began to be recognized by the courts in the United States. Courts today conduct a balancing test to determine if restrictive covenants can be imposed on an employee, even if it limits his or her livelihood, if the restrictive covenant is necessary to protect an employer's legitimate business interest.

## **II. Pennsylvania Law on Restrictive Covenants**

In Hess v. Gebhard & Co., Inc., 70 Pa. 148 (Pa. 2002) the Supreme Court of Pennsylvania recognized that Pennsylvania courts typically disfavor restrictive covenants in employment, however, the Supreme Court of Pennsylvania permitted enforcement of restrictive covenants not to compete if the following three conditions are met, the restrictive covenants are: (1) incident to the employment relationship; (2) reasonably necessary to protect the interest of the employer; and (3) reasonably limited in time and geography. The Hess Court found that if an employer drafts restrictive covenants in an overly broad manner a court has the equitable power to declare the restrictive covenant void or modify it and enforce it in a limited fashion against the employee.

The Hess Court stated a court must "balance the employer's protectable business interest against the interest of the employee in earning a living in his or her chosen profession, trade or occupation, and then balance the result against the interest of the public" to determine if restrictive covenants are valid and enforceable. In Pennsylvania, protectable business interests of employers include protecting trade secrets, confidential information, and good will (the positive reputation enjoyed by a company).

## **III. Factors Used to Determine if a Restrictive Covenant will be Enforced**

### **1. Time and Duration**

Restrictive covenants will not be enforced if they are for a continual and unending time period or duration. Courts, such as Hess, have repeatedly found that a restrictive covenant must be reasonable in their time and duration. However, a reasonable time or duration can vary widely and are often industry specific. Therefore, when drafting restrictive covenants the legitimate business interest that the employer is seeking to protect must be closely examined to determine what a reasonable duration or time period for the restrictive covenant will be.

### **2. Geographical Restrictions**

A reasonable geographical limitation is another of the three requirements necessary to enforce restrictive covenants listed by the Supreme Court of Pennsylvania in Hess. However, what constitutes a reasonable geographical restriction differs depending on the employee's position. Most courts consider the employee's geographical range during the course of his employment. For example, if the employee was a sales representative for the tri-state area then a reasonable geographical limitation would be the tri-state area.

### **3. Involuntary Termination of an Employee**

Another factor that is considered by Pennsylvania courts, in enforcing restrictive covenants, is to what extent an employee's involuntary termination should be a deciding factor. In Insulation Corp. of America v. Brobston, 446 Pa. Super. 520 (Pa. Super. 1995), the Superior Court of Pennsylvania found that when an employer terminated his employee for "failing to promote his employer's interest" the employer was essentially deeming the employee worthless. The Court then stated that if the employee was worthless and insignificant to the employer the employer's need to protect itself by a restrictive covenant was diminished. This caused subsequent employers to question the value of the restrictive covenants and if they would become unenforceable when an employee was involuntarily terminated.

However, later courts, such as the Pennsylvania Superior Court in Misset v. HUB International Pennsylvania, LLC, 2010 Pa. Super. 178 (Pa. Super. 2010) clarified the earlier Brobston decision and stated that the "termination of an employee alone would not serve to bar the employer's right" to enforce restrictive covenants found in employment contracts. The Court found that even though the employee was involuntarily terminated, he had access to confidential information of the employer that would adversely affect his employer if the employee was able to disclose such information to the employer's competitors or solicit the employer's customers. As recently as last month, on July 27, 2011, in Shepherd v. Pittsburgh Glass Workers, LLC, 2011 Pa. Super. 156 (Pa. Super. 2011), the Superior Court of Pennsylvania reaffirmed the legal concept that a restrictive covenant can be enforced when an employee is involuntarily terminated, however, the employee's termination is a factor that may be considered, on a case-by-case basis, by the court in analyzing whether the restrictive covenant may be enforced.

### **4. Consideration**

Another factor that must be contemplated by the court is whether any consideration (an exchange for value) was given to the employee in exchange for the employee agreeing to the restrictive covenant. In Shepherd, the court refused to enforce a restrictive covenant that was not supported by consideration, even if the terms of the restrictive covenant were reasonable. This is because no contract is enforceable without consideration. Typically, when an employee first enters into an employment contract, the offer of employment is the consideration offered in exchange for entering into the restrictive covenant.

Nevertheless, restrictive covenants may be found void and unenforceable, due to a lack of consideration, if an employee agrees to restrictive covenant after he or she has already been employed by the employer if no subsequent consideration is given. In Shepherd, the Court held that an employer's restrictive covenant against an employee was unenforceable since the employee had already worked for the employer when the restrictive covenant was entered into and the employee received no additional consideration for agreeing to the restrictive covenant.

Therefore, if an employer wishes its current employees to enter into restrictive covenants with their employer additional consideration must be given. This may include, but is not limited to, a promotion with additional training and a raise, additional compensation or severance and/or payments to the employee during the time period during which the employee will be barred from working for a competitor.

## **IV. Remedies/Relief**

Restrictive covenants are typically enforced by courts through a preliminary injunction (a court

order to refrain). In Shepherd, the Court found at an employer must show the following requirements for a preliminary injunction to be granted:

(1) relief is necessary to prevent immediate and irreparable harm that cannot be adequately compensated by money damages; (2) greater injury will occur from refusing to grant the injunction than from granting it; (3) the injunction will restore the parties to their status quo as it existed before the alleged wrong conduct; (4) the [employer] is likely to prevail on the merits; (5) the injunction is reasonably suited to abate the offending activity; and, (6) the public interest will not be harmed if the injunction is granted.

Often times the grant of the preliminary injunction will be dependent upon the employer posting a bond as well. Restrictive covenants can be drafted to include the employee's consent to an order of injunctive relief without the posting of a bond; however, courts have both enforced and rejected such provisions.

Alternatively, employers may also add a liquidated damages section to restrictive covenants; this will provide the employer with money damages should the employee fail to adhere to the restrictive covenant. However, this will likely preclude a court from ordering injunctive relief since the employer and employee have agreed to monetary damages for a breach of the restrictive covenant.

#### **V. Choice of Law/Venue**

Choice of law and venue should also be addressed by the employer and included in any restrictive covenants. While this article has focused primarily on Pennsylvania's approach and requirements for restrictive covenants, their enforcement vastly differs from state to state. For instance, in some states, such as California, restrictive covenants in employment contracts are prohibited and will not be enforced.

A choice of law section allows an employer to designate, and the employee to agree, that a particular state's laws will apply, even if the litigation is brought in a different state. Therefore, if a restrictive covenant is drafted with a choice of law section designating that Pennsylvania law controls, then Pennsylvania law will be applicable no matter where the enforcement proceeding is brought.

A venue section differs, from a choice of law section, as it designates the forum where the litigation, if any, will occur. A choice of law and venue section is important if an employer is centrally located but has personnel spread through various states, because it allows the employer the convenience of choosing the state law and venue. For instance, if a company is located in Philadelphia, Pennsylvania but has sales employees through out New Jersey, Delaware, and New York, the employer and employee can designate Pennsylvania as the choice of law and Philadelphia as the proper venue. The employer will not be forced to travel to various states to enforce its restrictive covenants.

#### **VI. Assignment of Restrictive Covenants**

Another concern that an employer should bear in mind when drafting restrictive covenants is to add an assignment clause to the employee's employment contract. In Hess, the employer failed to include an assignment clause, so when the company was sold the subsequent employer had no right to enforce the restrictive covenant against the former employee and the former employer had no legitimate business interest to protect since the business had been sold. The Court expressly stated, "a restrictive covenant not to compete, contained in an employment agreement, is not assignable to the

purchasing business entity, in the absence of a specific assignability provision, where the covenant is included in a sale of assets.”

## **VII. Conclusion**

Restrictive covenants allow employers to protect their trade secrets, customer base and other legitimate interest by restricting former employees from disclosing confidential information and/or working for direct competitors, however, great caution must be taken in drafting restrictive covenants or the court will find them to be void and unenforceable.

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### **UPCOMING CLE and CPE SEMINARS**

**Joseph R. Pozzuolo, Esquire and Jeffrey S. Pozzuolo, Esquire**

Thursday September 29<sup>th</sup>

6pm-9:30pm

“A Graying Population: Estate Planning for the Aging Middle Class Suburban Client for the General Practitioner and CPA”

Penn State Abington Campus

611 Facility

1475 Old York Road

Abington, PA 19001

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**Joseph R. Pozzuolo, Esquire**

Wednesday October 19<sup>th</sup>

9am

“A CPE Seminar Sponsored by the Montgomery County Society of CPAs”

The Cedarbrook Country Club

180 Penllyn Blue Bell Pike

Blue Bell, PA 19422

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**Judith P. Rodden, Esquire and Leslie M. Ibanez, Esquire**

Thursday October 20<sup>th</sup>

1pm-5pm

“Employment Law in the New Technological Age”

Penn State University

Cooperation Extension (Doylestown)

1282 Almshouse Road  
Neshaminy Manor Center  
Doylestown, PA 18901-2896

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**Joseph R. Pozzuolo, Esquire and Jeffrey S. Pozzuolo, Esquire**

Wednesday December 7<sup>th</sup>

8am-12pm

“The Closely Held Business Bootcamp for the General Practitioner and CPA Including Ethics”

Penn State University

Cooperation Extension (Doylestown)

1282 Almshouse Road  
Neshaminy Manor Center  
Doylestown, PA 18901-2896

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### **Publications**

All of the following professional publications and past newsletters written by attorneys of this office are available by clicking here: [http://pozzuolo.com/Pubs Articles.shtml](http://pozzuolo.com/Pubs%20Articles.shtml)

### **Corporate/Tax**

Design Buy-Sell Agreements For Maximum Utility

Deferred Compensation Rewards And Retains Key Employees

How To Use Non-Qualified Deferred Compensation Arrangements As A Business, Retirement And Tax Planning Tool

Protecting A Client's Business From Unfair Competition Using Restrictive Covenants

Money Purchase Pension Plan Falls Out Of Favor

Why An Employment Contract Is Mandatory

What Type of Qualified Corporate Retirement Plan Best Serves Your Business, Tax And Retirement Needs

Structuring Loans From Qualified Plans - How To Handle The Strict Tax Rules

How An S Corporation Avoids The Double Taxation Incurred When Excessive Compensation Is Treated As A Dividend

Bankruptcy - How To Prevent It And How To Cope With It Should It Happen To Your Business

How To Look, Act And Sound Like A Professional Corporation

How Mortgage Lenders Should Draft Broker Agreements To Avoid RESPA Violations

How to Structure a Suitable Buy-Sell Agreement

## **Estate Planning**

Estate Planning For Pet Owners

The Limited Liability Company -A Sophisticated Tool For Estate Planning

Diversify Strategies For An Effective Estate Plan

Use Wills To Maximize Family Protection And Minimize Tax

Six Proven Estate Planning Techniques

Divorce Raises The Need For Performing An Estate Planning Review

Divorce and Estate Planning

Remarriage Situations Can Raise Special Estate Planning Considerations

College Funding Tool Offers Estate Planning Advantage

Drafting The Durable Power Of Attorney For Wealth Protection Purposes

Why Living Wills Advance Directives Are An Essential Part Of Estate Planning

Special Needs Trust - An Estate Planning Tool For The Disabled

Adapt Estate Planning Strategies to Fit the Needs of Same-Sex Couples

***Actual resolution of legal issues depends upon many factors, including variations of facts and state laws. This newsletter is not intended to provide legal advice on specific subjects. It is to provide insight into legal developments and issues. You should always consult with legal counsel before taking any action on matters covered in our updates.***

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