

PERSPECTIVES

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The **DEVIL** is in the Details of Restrictive Covenants

Faced with a shrinking customer base and intense competition, many companies have shifted their focus to protecting and expanding existing business relationships by looking inward – at their employees. Employees are routinely required to sign agreements prohibiting them from competing with their employers or soliciting their employers' customers and fellow employees, for one or more years following their separation of employment. These agreements, known as "restrictive covenants," usually contain other prohibitions, such as barring employees from disclosing or using a former employer's confidential information and trade secrets. Employers also have become more aggressive in enforcing restrictive covenants, and frequently run into court asking judges to immediately enjoin, or stop, former employees from working for competitors or contacting customers until the court has a full opportunity to decide whether the restrictive covenants are reasonable and enforceable. Not surprisingly, the courts are generally reluctant to enforce restrictive covenants, especially where the employee was involuntarily terminated through no fault of his or her own.

It is against this backdrop that, on June 2, 2010, the United States Court of Appeals for the Third Circuit issued its decision in *PharMethod, Inc. v. Michael Caserta*. PharMethod provides Pennsylvania employers with a detailed primer of "do's and don'ts" for preparing and enforcing restrictive covenants, and requires courts to consider whether otherwise valid restrictive covenants can be enforced against employees who have been terminated.

In *PharMethod*, Michael Caserta was terminated from employment as the company's President. Caserta had worked at PharMethod since its inception four years earlier, and previously worked for a division of Rentacom doing business as "Dyventive, Inc." At the time of his hire, Caserta signed an employment agreement with Dyventive that contained various restrictive covenants. Six months later, the Dyventive division was "spun off" to form PharMethod.

Shortly after terminating Caserta "without cause" in August 2009, PharMethod sued Caserta in federal district court in Philadelphia, claiming that Caserta was violating the restrictive covenants in his employment agreement. As part of its complaint, PharMethod alleged that "the business that became PharMethod, Inc. was operated as part of Dyventive," and that Caserta's agreement was assigned to PharMethod when he became employed by PharMethod. Relying on some assignment language in the agreement, PharMethod claimed that it was the "successor" company to Dyventive and, as such, was entitled to enforce the

restrictive covenants in the agreement. PharMethod also alleged that Caserta was disparaging PharMethod to its customers, and using its confidential information in an effort to solicit its customers. PharMethod asked the court to issue a preliminary injunction prohibiting Caserta from “competing with PharMethod, soliciting PharMethod’s customers, disclosing or using PharMethod’s confidential business information and trade secrets, disparaging PharMethod, and otherwise violating the restrictive covenant for a period of one year” from his termination date.

The trial judge agreed to enforce the restrictive covenants and entered an injunction against Caserta, finding that he violated the covenants in his April, 2005 agreement with Rentacom d/b/a Dyventive. In a summary order, the judge concluded that injunctive relief was required to prevent immediate and irreparable harm to PharMethod, that “PharMethod’s right to relief is clear,” and that the requested injunction was “reasonably suited to abate” Caserta’s “wrongful conduct.” Caserta appealed the decision, citing various procedural flaws and legal arguments. Among other things, he argued that the court failed to adequately consider his argument that Pennsylvania law prevents PharMethod from enforcing the covenants because it terminated his employment.

The Appeals Court reversed the injunction, concluding that the trial judge did not sufficiently evaluate or explain his decision to enforce the restrictive covenants. More importantly, the Appeals Court went on to provide a detailed checklist of the “do’s and don’ts” of preparing and enforcing restrictive covenants in Pennsylvania. Although this is not an exhaustive list, employers should ensure that their existing **and** future restrictive covenants at least satisfy these minimal requirements.

- **Restrictive covenants must be contained in agreements incident to employment.** In Pennsylvania, employees must sign agreements containing restrictive covenants on or before the first day of work. However, some courts have enforced covenants that were signed several days later, where the employee was told he would be subject to the covenants before he began work.
- **The party seeking to enforce a restrictive covenant must have a legal interest in the underlying agreement.** This issue typically arises when the original employer has gone through a merger, change in control, asset sale or other change.
- **Assignment clauses should be sufficiently broad to encompass the party seeking to enforce the covenant.** The Appeals Court stated in *PharMethod* that the generic assignment clause in Caserta’s agreement was not sufficient to show that Rentacom actually assigned its interest in Caserta’s agreement to PharMethod. In the event of a corporate change, the old employer should specifically assign each agreement containing restrictive covenants to the new employer.
- **Restrictive covenants must be reasonably necessary to protect the employer’s legitimate business interests.** The Appeals Court cautioned employers to make sure that covenants are “narrowly tailored to protect the employer’s legitimate interests,” such as “trade secrets, confidential information, good will, and unique or extraordinary skills.” By contrast, eliminating competition or gaining an economic advantage is not a legitimate business interest. Employers also should restrict access to confidential information and designate the information as “Confidential.”

- **Restrictive covenants must be reasonably limited in time.** In Pennsylvania, restrictive covenants for a period up to two years are routinely found reasonable. However, courts have refused to enforce shorter covenants, and sometimes agreed to enforce longer covenants. Courts consider the employee's length of service, position in the company, the nature of the employer's protectable interests, and other factors.
- **Restrictive covenants must be reasonably limited in geography.** The Appeals Court cautioned that covenants without any geographic limits, or very broad limits, will only be enforced only where the employee's duties and customers are equally broad. Alternatively, Pennsylvania courts sometimes permit employers to replace geographic restrictions with lists of specific companies or customers that are "off limits" to former employees.
- **Pennsylvania law permits courts to reduce an overbroad restriction and then enforce that reduced restriction, but a "gratuitously overbroad" restriction may serve to invalidate the entire agreement.** A covenant may be "gratuitously overbroad" if it would prevent the employee from anywhere working in the industry, or eliminate competition altogether.
- **Employees cannot waive certain legal requirements by agreement.** In *PharMethod*, the Appeals Court held that the trial judge improperly relied on the employee's agreement to waive the posting of a bond or security, because court rules require the posting of a bond in that situation. While some courts have accepted such waivers in the past, employers should not expect to rely on such waivers in the future.
- **Employers that terminate employees in Pennsylvania may be unable to enforce restrictive covenants against them.** The Appeals Court has effectively endorsed a Pennsylvania Superior Court ruling that where an employer terminates an employee subject to an otherwise enforceable restrictive covenant, the employer loses its legitimate business interest subject to protection if the employee has been "effectively discarded as worthless." Employers should not expect to enforce covenants against employees that are terminated for poor performance, lack of business, and so forth. Employers seeking to enforce covenants against terminated employees should ensure that they document the reason for termination and can show that the employee was terminated for misconduct or other reasons.

In sum, an employer's use of employment agreements that contain restrictive covenants can be an effective tool in protecting the employer's legitimate interests and proprietary business information, so long as the restrictions placed upon the employee are reasonable. Although the enforceability of restrictive covenants is routinely subject to uncertainty and every situation unique, any such uncertainty can be reduced with a well-crafted, narrowly tailored employment agreement that contains covenants and limitations that are both reasonable and necessary to protect the employer's interests.

Douglas C. Hart is a senior associate in the Pittsburgh office of Cohen Seglias Pallas Greenhall & Furman, PC and a member of the firm's Labor & Employment Group. Melissa C. Angeline is a senior associate in the firm's Philadelphia office and a member of the firm's Labor & Employment Group, where her practice is concentrated on representing and counseling employers in all aspects of employment law. They can be reached at dhart@cohenseglias.com and mangeline@cohenseglias.com, respectively.