

DAMAGES AND FORFEITURES IN RESTRICTIVE COVENANT, TRADE SECRET, and
EMPLOYEE DEFECTION/MOBILITY CASES

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I. INTRODUCTION

The issues that surround damage awards in employee defection/mobility cases have often taken a back seat to the issues that arise in the injunctive phase of these cases. This is understandable to the extent that injunctive relief carries with it the urgency of stopping competitive activity by employees that may threaten to destroy a business. Yet damages issues are also important, perhaps increasingly so as disputes arise over the use of forfeiture clauses and juries and courts issue large damage awards.

In broad terms, the procedure for obtaining damages in employee defection/mobility cases is no different from other contract or tort cases. In *Omicron Systems, Inc. v. Weiner*, 860 A.2d 554, 564-565 (Pa. Super. 2004), the Pennsylvania Superior Court held:

The general rule in this Commonwealth is that the plaintiff bears the burden of proof as to damages. The determination of damages is a factual question to be decided by the fact-finder. The fact-finder must assess the testimony, by weighing the evidence and determining its credibility, and by accepting or rejecting the estimates of the damages given by the witnesses.

Omicron Systems, Inc. v. Weiner, supra, citing Judge Technical Services, Inc. v. Clancy, 813 A.2d 879, 885 (Pa. Super. 2002).

In all employee defection/mobility cases, the trier of fact has a certain degree of flexibility in establishing a damage award. To a significant degree, the damages that a court may award under the various causes of action for employee defections are interchangeable. In *Latuszewski v. Valic Financial Advisors, Inc.*, 2007 WL 4462739 (W.D. Pa. Dec. 19, 2007), the Court held that a damage award was appropriate under the alternative theories of breach of contract, misappropriation of trade secrets, breach of the duty of loyalty, or interference with contractual relations.

II. DAMAGES FOR BREACH OF A RESTRICTIVE COVENANT

A. Elements of a Damage Claim

1. The existence of an enforceable agreement

- a. Ancillary Nature- The covenant must be ancillary to either an employment relationship or another lawful transaction between the parties. Aside from employment agreements, restrictive covenants are found in partnership or shareholder agreements (*See Capozzi v. Latsha and Capozzi, P.C.*, 797 A.2d 314 (Pa. Super. 2002)); agreements for the sale of a business; franchise agreements; license agreements; independent contracts for services; and joint venture agreements, and many other agreements.

b. Consideration

To be enforceable, a restrictive covenant must be supported by adequate consideration. In an employment context, adequate consideration is found either in the commencement of employment, or in a substantial beneficial change in the terms and conditions of employment. *See Davis & Warde, Inc. v. Tripodi*, 420 Pa. Super. 450, 616 A.2d 1384 (1992); *Maintenance Specialties, Inc. v. Gottus*, 455 Pa. 327, 314 A.2d 279, 281 (1974). The mere continuation of employment under pre-existing terms is not sufficient consideration to support a non-compete under Pennsylvania law. *Wincup Holdings, Inc. v. Hernandez*, 2004 WL 953400 (E.D. Pa. May 3, 2004).

NOTE: Reasonableness of a restrictive covenant is not at issue in an action for damages for breach of the covenant. *Boyce v. Smith-Edwards-Dunlap Co.*, 398 Pa. Super. 345, 580 A.2d 1382 (1990).

2. Breach of a duty imposed by the contract

Courts will scrutinize a restrictive covenant closely to see whether a violation of the covenant has occurred. Courts will only enforce the covenant if the restriction is applicable and is being violated. The following questions arise in considering whether a covenant has been breached:

a. Is the restriction even applicable?

In *Stone & Edwards Insurance Agency Inc. v. Stumpf*, 31 Pa. D. & C. 4th 462 (Dauphin Co. 1996), the restrictive covenant applied if an insurance agent sold his book of business back to his employer. The Court held that the restrictive covenant did not apply where the employee had simply left the agency without selling his book back to the employer. In *Judge Associates, Inc. v. Belcher*, 71 Pa. D. & C. 2d 112 (Phila. Co. 1975), the Court refused to enforce an otherwise valid restrictive covenant because the covenant applied only when the employee voluntarily quit, and the employer had fired the employee in this case.

b. Does the ex-employee's conduct violate the restriction?

In the case of *Harry Blackwood, Inc. v. Caputo*, 290 Pa. Super. 140, 434 A.2d 169 (1981), the restrictive covenant prohibited solicitation or diverting or taking away customers. The covenant did not prohibit servicing customers, however. Therefore, the Court held that an insurance agent did not violate the restrictive covenant if the agent wrote or sold insurance to agency customers that had

sought the agent out, without any solicitation or diversionary activity by the agent. In *Doyle Consulting Group, Inc. v. Stoffel*, 2004 WL 362316 (C.C.P., Phila. Co. 2004), *affirmed without opinion*, 869 A.2d 18 (Pa. Super. 2004), the covenant prohibited soliciting customers but said nothing about former customers. The courts held that solicitation of former customers did not violate the covenant.

3. Proximate cause of damage

In *Omicron Systems, Inc. v. Weiner*, 860 A.2d 554, 564-565 (Pa. Super. 2004), the Pennsylvania Superior Court held:

Although the fact-finder may not render a verdict based on sheer conjecture or guesswork, it may use a measure of speculation in estimating damages. The fact-finder may make a just and reasonable estimate of the damage based on relevant data, and in such circumstances may act on probable, inferential, as well as direct and positive proof.

- a. Under Pennsylvania law, a plaintiff suing for violation of a restrictive covenant has to establish damages with reasonable certainty, not absolute certainty (*Scobell, Inc. v. Schade*, 455 Pa. Super. 414, 688 A.2d 715, 718-19 (1997)). In restrictive covenant cases, damages are often difficult to ascertain or compute with precision (*Records Center, Inc. v. Comprehensive Management, Inc.*, 363 Pa. Super. 79, 525 A.2d 433 (1987); *Synthes (USA) v. Global Medical, Inc.*, 2007 WL 2043184, *7 (E.D. Pa. July 12, 2007)).
- b. Where an ex-employer has lost business from the breach of a restrictive covenant, the courts require the ex-employer to show (1) that a new employer obtained the business because the ex-employees went to work for the new employer and (2) that, but for the new employer's bid, the ex-employer (rather than a third party) would have obtained or retained a contract. *Scobell, supra*, 455 Pa. Super. 414 at 423, 688 A.2d 715 at 719.
- c. Showing a list of customers that a new employer serves does not establish with "reasonable certainty" that the new employer was the proximate cause of a plaintiff's loss of business. *See Id*; *see also Telamerica Media, Inc. v. AMN Television*, 2002 WL 32373712 (E.D. Pa. Sept. 26, 2002).

- d. It may be necessary to exclude the ex-employer's own limitations or deficiencies as a causative factor. In each of the following cases, courts held that factors within the ex-employer's control caused the employer to lose business, rather than competition by the ex-employee:
- (i) Customer dissatisfaction (*Rapid Freight Systems v. Ofer Express LLC*, 2003 WL 1848211 (Phila. Co. Feb. 28, 2003)).
 - (ii) Poor management of business, including poor service and shipping delays (*Clarke Transportation Services, Inc. v. Haskins*, 2006 WL 1620175 (E.D. Pa. June 8, 2006)).
 - (iii) Actual withdrawal from business or lack of desire to compete in a particular area (*Bilec v. Auburn Associates, Inc.*, 403 Pa. Super. 176, 588 A.2d 538 (1991); *Thomas Jefferson University v. Wapner*, 2004 WL 2474098 (Phila.Co. Oct. 22, 2004), *affirmed*, 903 A.2d 565 (Pa. Super. 2006)).
 - (iv) Inability to compete in a particular geographic area because of lack of licensure (*Ferarolis v. International Recovery Systems, Inc.*, 2006 WL 1371187 (E.D. Pa. May 18, 2006) (upholding jury verdict that employee could not forfeit stock interest for being sued for violating a non-compete, where employee may have worked only in states where employer had no license)).

B. What Types of Compensatory Damages are Recoverable?

Among the elements recognized as possible damages in restrictive covenant and unfair competition cases are the following:

1. The non-breaching party's lost profits (*Scobell, Inc. v. Schade, supra*; *Certified Laboratories of Texas, Inc. v. Rubinson*, 303 F. Supp. 1014 (E.D. Pa. 1969) (recognizing right to accounting for lost profits). However, the lost profits should be *actual* lost profits, not projected lost profits. *Delahanty v. First Pennsylvania Bank*, 464 A.2d 1243, 1261 (1983).
2. Lost orders (*Certified Laboratories of Texas, Inc. v. Rubinson, supra* (holding damages obtainable but proof deficient)).
3. Lost goodwill (*Certified Laboratories of Texas, Inc. v. Rubinson, supra* (holding damages obtainable but proof deficient)).

4. Restitution of unjust enrichment (*Synthes (USA) v. Global Medical, Inc.*, 2007 WL 2043184, *7 (E.D. Pa. July 12, 2007)).

C. Other Types of Damages

1. Disgorgement of employee earnings- Absent a contractual provision, Pennsylvania law does not allow a plaintiff ex-employer to recover damages in the form of an ex-employee's earnings from a new employer.

a. Commissions- *American Air Filter Co., Inc. v. McNichol*, 527 F.2d 1297, 1300-01 (3rd Cir. 1975) (holding that forfeiture of commissions would "merely impose a penalty").

b. Profits Earned by Breaching Parties- *Fishkin v. Susquehanna Partners, G.P.*, 2007 WL 560703, *4-*5 (E.D. Pa. Feb. 12, 2007), and 563 F. Supp. 2d 547, 2008 WL 2468616, * 36-37 (E.D. Pa. June 17, 2008) (holding that disgorgement of earnings with a new employer was not a proper measure of damages; the proper measure of damages was the profit the ex-employer had lost, not the benefit that the ex-employees had gained). The District Court in *Fishkin* relied on the *American Air Filter* decision in reaching this conclusion. The Court held, "Like the plaintiff in *Air Filter*, [plaintiff] here is seeking to measure its damages for breach of a non-competition agreement by the breaching party's profits rather than by its own losses. As found by the *Air Filter* court, however, this is not an appropriate measure of damages for breach of a non-competition agreement, and there is no relationship between the profits ... made by competing with [plaintiff] and the compensable losses [plaintiff] suffered." *Fishkin*, 2007 WL 560703, at ** 4-5. The Court in *Fishkin* noted that the plaintiff had not included a provision for disgorgement in its contract. It had included a liquidated damages provision but had elected not to sue under this provision.

c. However, disgorgement of pay is a proper remedy when the employee competes with the employer while still employed. In this situation, a constructive trust may be imposed on all revenue generated from this unlawful competition and an accounting may be ordered. *Plate Fabrication and Machining Co., Inc. v. Beiler*, 2006 WL 14515, *8 (E.D. Pa. Jan. 3, 2006). This is essentially the same remedy as the remedy for a breach of the duty of loyalty.

2. Punitive damages- See *Certified Laboratories of Texas, Inc. v. Rubinson*, *supra*.

3. Liquidated damages may be awarded in a restrictive covenant case if the covenant permits liquidated damages. See *Omicron Systems, Inc. v. Weiner*, 860 A.2d 554 (Pa. Super. 2004); *DeMuth v. Miller*, 438 Pa. Super. 437, 652 A.2d 891 (1995); *Geisinger Clinic v. DiCuccio*, 414 Pa. Super. 85, 606 A.2d 509 (1992). A liquidated damage provision should be a measure of foreseeable business losses or loss of goodwill for a limited period of time, where the actual loss may be difficult to ascertain. If the liquidated amount is excessive or if no measure of compensation is intended, the damage clause is a penalty. *Geisinger Clinic v. DiCuccio, supra* at 606 A.2d 517.

- a. The courts have been generous in interpreting contractual provisions to allow recovery of liquidated damages. In *Omicron Systems, Inc. v. Weiner*, the Superior Court upheld the trial court's \$238,000 award of an amount equal to the salary paid to the individual ex-employee defendant by a new employer up to the beginning of trial as "liquidated" damages. The Court found that the restrictive covenant contained a liquidated damages clause allowing recovery of "damages and an equitable accounting of all earnings, profits, and other benefits arising from . . . violation [of the non-compete]." The Court held that this clause justified the award of liquidated damages.
- b. Liquidated damage clauses can be Draconian; for example, in *DeMuth v. Miller*, 438 Pa. Super. 437, 652 A.2d 891 (1995), a management consulting company entered into a five-year employment contract. The agreement contained a provision calling for a payment to the old employer of 125% of the previous 12 months' charges for each of the employer's clients who left with the employee if the employee established a professional management or management consulting firm, in the event that the employer terminated the employee for cause. "Cause" was defined to include homosexuality. The employee was terminated for cause after appearing at a gay-rights event. The ex-employee then formed a competing business and took a substantial amount of business from the ex-employer. The court upheld the liquidated damages clause and the ex-employee had to pay the ex-employer the 125% figure set by the contract.
- c. In *Key Consolidated 2000, Inc. v. Troost*, 432 F. Supp. 2d 484 (E.D. Pa. 2006) the Court refused to dismiss a contract claim based on a liquidated damage clause requiring a home inspector to repay the employer for training costs, in the amount of \$10,000, if the inspector derived any income from services outside the inspection organization. See, *Key Consolidated 2000, Inc. v. Troost*, 432 F. Supp. 2d at 487.

- d. The existence of a liquidated damages provision does not preclude injunctive relief (*Bettinger v. Carl Berke Associates, Inc.*, 455 Pa. 100, 314 A.2d 296 (1974); *Omicron Systems, Inc. v. Weiner*, 860 A.2d 554, 565 (Pa. Super. 2004)).
- e. Other courts have been reluctant to impose both liquidated damages and injunctive relief. In *Lehigh Valley Bone, Muscle & Joint Group LLC v. Puccio*, 75 Pa. D. & C. 4th 176 (Lehigh County 2005), *affirmed without opinion*, 903 A.2d 61 (Pa. Super. 2006), the court imposed \$100,000 liquidated damages on doctor who competed in violation of a two-year, 25 mile non-compete, but refused to enjoin competition. Other courts have enjoined competition and refused to enforce liquidated damage clauses (*Medical Wellness Associates, P.C. v. Heithaus*, 51 Pa. D. & C. 4th 1 (Westmoreland Co. 2001)). In *Fraser v. Nationwide Mutual Insurance Co.*, the Court treated a compensation forfeiture provision as an alternative to injunctive relief for breach of a restrictive covenant. *See Fraser v. Nationwide Mutual Insurance Co.*, 334 F. Supp. 2d 755, 760-761 (E.D. Pa. 2004).

4. Attorney's fees

- a. Attorneys' fees are awardable as an element of damages or costs in restrictive covenant litigation. *See Certified Laboratories of Texas, Inc. v. Rubinson*, 303 F. Supp. 1014 (E.D. Pa. 1969).
- b. A contractual provision for attorney's fees was upheld in *Maaco Enterprises v. Bremner*, 1998 WL 669936 (E.D. Pa. 1998) (franchise case).
- c. It is essential to state a specific claim for attorney's fees in the prayer for relief in Pennsylvania. In *Omicron Systems, Inc. v. Weiner*, 860 A.2d 554, 566 (Pa. Super. 2004), the Superior Court reversed an award for attorney's fees on the ground that the plaintiff had failed to properly state a claim for attorney's fees in the prayer for relief in the complaint.
- d. In *Cardiac Consultants, P.C. v. Feinberg*, 70 Pa. D. & C. 4th 536, 558 (Lancaster Co. 2004), the trial court awarded attorneys' fees to a successful defendant who had opposed the entry of an injunction to enforce a restrictive covenant. The restrictive covenant contained a clause that awarded attorneys' fees to the prevailing party.

5. Reimbursement of training costs - *Key Consolidated, Inc. v. Troost*, 432 F. Supp. 2d 484 (M.D. Pa. 2006). A home inspection company sought to

recover training expenses upon an employee's departure and competition. The payment for these training expenses was required under the agreement. The Court upheld this agreement as a permissible contract, and refused to grant a motion to dismiss this complaint.

D. Contempt Penalties

1. Monetary damages- Where a party is guilty of contempt of an injunction enforcing a restrictive covenant, the court may award compensatory damages in the form of attorneys' fees, investigation costs, deposition fees, and subpoena and witness fees incurred as a result of the contemptuous acts. *Mrozek v. James*, 780 A.2d 670, 674 (Pa. Super. 2001).

2. Incarceration- In *Dentrust Dental International v. Rosenberg*, 75 Pa. D. & C. 4th 42 (C.C.P. Bucks Co. 2005), the Bucks County Court of Common Pleas upheld a sentence of incarceration in addition to a \$250,000 contempt sanction against a dentist who had "flagrantly decided" not to comply with a preliminary injunction that prohibited violation of a restrictive covenant. The covenant in question was a two-year restriction that prohibited solicitation from and serving ex-customers. The debt in *Dentrust* has been held non-dischargeable in bankruptcy because an order of contempt constitutes "willful and malicious injury by the debtor to another entity or the property of another entity" under the Bankruptcy Code, 11 U.S.C. §523(a) (6). See *In Re Rosenberg*, 2007 WL 2156282 (Bankr. N.D. Ohio July 23, 2007).

III. FORFEITURES OF COMPENSATION OR EQUITY INTERESTS FOR BREACH OF RESTRICTIVE COVENANT

A. Introduction

An alternative to injunctive relief or damages awarded at trial exists for an employer enforcing a non-compete or other restrictive covenant – the ability to force the employee to forfeit an item of value, in the form of either post-employment compensation or a share in the ownership of a business. Courts in Pennsylvania and other jurisdictions have generally upheld these forfeitures, as long as the forfeiture is covered explicitly in a contract. See *Bilec v. Auburn Associates, Inc.*, 403 Pa. Super. 176, 588 A.2d 538 (1991); *Capozzi v. Latsha and Capozzi, P.C.*, 797 A.2d 314 (Pa. Super. 2002); *Davis v. Buckham*, 280 Pa. Super. 106, 421 A.2d 427 (1980). The whole area of forfeitures has become the subject of increasing litigation in recent years. There is increasing conflict in the case law on the need for reasonableness in the forfeiture agreements and on what circumstances allow the employee to avoid the forfeiture.

The "employee choice doctrine" provides that an employee who has an agreement with an employer, requiring a forfeiture of deferred compensation/partnership shares/stock rights if the employee competes with the employer, has the choice between either (1) refraining from competing and obtaining the benefit; or (2) competing and forfeiting the benefit. Generally, under this doctrine, the non-competition/forfeiture agreement is not

