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Free Market Competition or Treason?  
**EMPLOYEE DUTY OF LOYALTY**  
A Précis for the Corporate Executive



**Third Edition**  
with 2016 Legislative Update

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**FREE MARKET COMPETITION OR TREASON?**

# **EMPLOYEE DUTY OF LOYALTY**

**A PRECIS FOR THE CORPORATE EXECUTIVE**

**WITH 2016 LEGISLATIVE UPDATE**

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(McLane Middleton, P.A. founded in 1919)**

## **ABOUT THE AUTHOR**

**Andrew P. Botti** : Andrew advises in-house counsel, corporate executives, and owners of closely held and family businesses on a wide variety of complex commercial, business and employment litigation matters. He was recently selected as a New England "Super Lawyer" in Business Litigation by Law & Politics and Boston magazines. He is also rated "AV" – the highest rating possible - by Martindale-Hubbell lawyer peer review. In September 2015 Andrew was appointed by Governor Charlie Baker to the state's Economic Development Planning Council. The Council is charged with developing a state-wide, comprehensive economic development plan, with measurable benchmarks. The plan will be submitted to the Massachusetts legislature for public hearing prior to being presented to the Governor for signature. Andrew also served on the Baker-Polito Transition Team.

Andrew presently serves on the Board of Directors of AIM, the Associated Industries of Massachusetts. AIM is the premier employer advocacy group in Massachusetts. The organization recently celebrated its 100<sup>th</sup> anniversary. Andrew served as Chairman of the Board of SBANE from 2009-2011. The Smaller Business Association of New England, is a 500 member strong organization founded in 1938 to advance the interests of smaller businesses throughout the six state region. In that capacity he founded the Women's Business Committee, initiated an e-newsletter for the organization, placed several women CEO's on the Board, and fought proposed non-compete reform legislation which was unfair to business owners.

Active in the local community, Andrew sits on the Board of Lazarus House, and is a member of the St. Augustine's Parish Council.

His articles, "Legislative Developments Concerning Non-competes," "Who owns customer goodwill, after all;" "Non-competes must be updated to remain effective;" and "SJC rejects court-imposed 'buy-out' of minority shareholders" appeared in *New England In-House* magazine. He is a contributing author to *Massachusetts Administrative Procedure*, a multi-volume treatise published by The Lawyers Co-operative Publishing Company, Rochester, New York. Andrew is a member of the International Association of Defense Counsel, and the Boston Bar Associations. He is a graduate of Columbia College (1983) and the Northeastern University School of Law (1991).

Andrew has the following published cases relating to his practice in the areas of business and employment litigation:

*Cleary v. American Capital, Ltd*, 59 F.Supp.3d 249 (D. Mass. 2014) (WARN Act claim);

*Leder v. Superintendent of Schools*, 465 Mass. 305 (2013) (amicus brief on private right of action);

*Cook, et. al. v. ACS State & Local Solutions, Inc.*, 663 F.3d 989 (8<sup>th</sup> Cir 2011) (class action re data privacy);

*Wiles v. Worldwide Information, Inc.*, 809 F.Supp.2d 1059 (W.D. Mo. 2011)(federal privacy law);

*Wiles, et. al. v. LocatePlus Holdings Corp.*, 2010 WL 3023909 (W.D. Mo.) (federal privacy law class action);

*Cook, et. al. v. ACS State & Local Solutions, Inc.*, 756 F.Supp.2d 1104 (W.D. Mo. 2010)(data privacy class action);

*Gil v. Vortex, LLC*, 697 F.Supp.2d 234 (D. Mass. 2010) (D. Mass.) (handicap discrimination);

*Corapi v. C & C Realty Development* (2009 WL 3430297) (Mass. App. Div. 2009) (broker's commission);

*Biffer v. Capital One Services, Inc.*, 2006 WL 387394 (D. Conn.) (identity theft);

*In re Gitto Corp.*, 321 B.R. 367 (Bankr. D. Mass. 2005);

*Kuhn v. Capital One Financial Corporation, Inc.*, 2004 Mass Super Lexis 514 (consumer class action);

*Christopher C. Clark v. The Stripe Law Firm LLP*, 320 F. Supp. 2d 1207 (W.D. Okla. 2004) (Civil RICO);

*Corporate Teledata, Inc. v. Thomas J. Sullivan, et al*, 15 Mass. L. Rptr. No. 32, 765 (2003) (denial of relief pursuant to Mass. R. Civ. P. 60(b));

*Corporate Teledata, Inc. v. Thomas J. Sullivan, et. al*, 15 Mass. L. Rptr. No. 20, 457 (2003) (dismissal as discovery sanction);

*In re: Malden Mills Industries, Inc., et. al. v. E.I. Du Pont de Nemours & Co., et. al*, 277 B.R. 449 (Bankr. D. Mass. 2002) (catastrophic property damage litigation);

*In re: Malden Mills Industries, Inc.*, 275 B.R. 670 (Bankr. D. Mass. 2002) (catastrophic property damage litigation);

*Big Top USA, Inc. v. The Whittem Group et. al.*, 998 F. Supp. 30 (D. Mass 1998) (trade dress infringement);

*Big Top USA, Inc. v. The Whittem Group et. al.*, 183 FRD 331 (D. Mass. 1998) (discovery sanctions);

*Price v. BIC Corporation*, 142 NH 386 (1997) (products liability);

*New Balance Athletic Shoe, Inc. v. Boston Edison Company*, 29 UCC Rep. Serv. 2d 397 (1996) (property damage);

*Vasapolli, et. al. v. Rostoff, et. al.*, 39 F. 3d 27 (1<sup>st</sup> Cir. 1994) (FDIC litigation);

*United States of America v. Instruments, S.A., Inc.*, 807 F. Supp. 811 (D.C. Cir. 1992) (constitutional challenge to federal procurement act).

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## **ABOUT MCLANE MIDDLETON, P.A.**

Founded in 1919, McLane Middleton is one of New England's premier full-service law firms, and has been for nearly 100 years. Practice areas include: Corporate, Trusts and Estates, Taxation, Real Estate/Land Use; Health Care; Education; Environmental/Energy; Government Affairs; Intellectual Property; Litigation and Employment Law.

McLane's nearly 100 lawyers are dedicated professionals who have built long-lasting collaborative relationships with a broad spectrum of local, national and international clients and organizations.

## **TABLE OF CONTENTS**

|   |       |
|---|-------|
| Employee Duty of Loyalty.....   | 1     |
| <i>(A summary of the current law)</i>   |       |
| <br>Latest Efforts at Non-compete Reform<br>in the Massachusetts Legislature.....   | <br>2 |
| <i>(The 2015-2017 Legislative Session)</i>  |       |
| <br>HISTORY: The Massachusetts Legislature's<br>Efforts Concerning Non-competes and other<br>Forms of Post-Employment Restrictive<br>Covenants..... | <br>3 |
| <i>(Efforts at Change since 2009)</i>   |       |
| <br>A Real-Life Illustration of the Need for Non-competes.....  | <br>4 |
| <i>(A reality check on the need for restrictive covenants)</i>  |       |
| <br>Non-compete Fact Sheet.....   | <br>5 |
| <i>(Salient facts surrounding non-competes)</i>   |       |
| <br>Why Non-compete Agreements are Needed.....  | <br>6 |
| <i>(The efficacy of such covenants)</i>   |       |
| <br>“That’s Not Fair!” Equitable Principles and<br>Remedies That Can Help Your Business.....  | <br>7 |
| <i>(The context of enforcement)</i>   |       |
| <br>Additional Articles.....  | <br>8 |
| <i>“Non-competes must be updated to remain effective”</i>   |       |
| <i>“Who owns customer goodwill, after all?”</i>   |       |
| <i>“Reach of retaliation claims expanded”</i>   |       |
| <i>“SJC rejects court-imposed ‘buy-out’ of minority shareholder”</i>  |       |

# CHAPTER 1

Loyal. adj. *Faithful to a person, ideal, custom, cause, or duty; of, relating to, or marked by loyalty....*

*The American Heritage Dictionary, 4<sup>th</sup> Ed.*

*"I'll take fifty percent efficiency to get one hundred percent loyalty."*

Samuel Goldwyn (1882-1974)

*"Honesty is the best policy."*

*Don Quixote, Part ii, Chapter xxxiii. Miguel de Cervantes (1547-1616)*

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## I. INTRODUCTION

What follows is an introduction to the issues raised by the law of employee duty of loyalty, and its relation to trade secrets and other proprietary business information. This area of the law often forms the basis for disputes arising between employers and their former employees. In particular, emphasis is placed upon those situations where ex-employees choose to compete in the same business with their former employers. It is this circumstance which seems to offer the greatest temptation for former employees to utilize wrongfully the information and knowledge gained in their prior positions, often to the detriment of their previous employer.

This work covers the topic of employee duty of loyalty with a broad brush. There will often be jurisdictional as well as judicial variations on the applicable law which must be considered. The Notes to Text are an integral part of this work and should be read along with the main text.

## II. REAL WORLD COMPETITION MAY MEAN UNFAIR COMPETITION

"An act or practice is likely to be judged unfair only if it substantially interferes with the ability of others to compete on the merits of their products or otherwise conflicts with accepted principles of public policy recognized by statute or common law." *Restatement (Third) Unfair*

Competition § 1, comment g (1995). What would you do if faced with one of the following situations?

A) The Exodus en Mass

The owner of a highly successful real estate brokerage business decides to take an extended European vacation with her husband of 30 years. The brokerage utilizes six full-time sales people, none of whom have signed a non-compete agreement. While the owner is away she leaves the brokerage in the hands of the six sales people, most of who have been with the brokerage for several years. Sometime during the owner's vacation of a lifetime, all of the salespeople submit their written resignations. When the owner returns, the office is silent and the resignation letters are on her desk.

It appears, too, that some of the company's files have been left askew, and many of the salespersons' rolodexes are missing. The owner then learns that all her former salespeople are now working literally across the street, at a competing brokerage. She is unable to confirm the status of many of the pending sales and leads of which she knew prior to her vacation.

B) The Flash-in-the-Pan Departure

The corporation is one of only a handful of companies located in the United States which manufacturers and markets sophisticated teleconferencing devices which generally sell for tens of thousands of dollars. Often larger corporate customers are willing to spend well over one hundred thousand dollars for state of the art teleconferencing systems and appurtenances which even fewer companies can provide. The competition for these sales is keen.

The corporation has employed a sales manager of outstanding skill and reputation. He is highly paid and well worth the money. He knows the industry and the potential customers extremely well. As a manager who actively participates in large sales calls with junior



salespersons, he is privy to some of the most sensitive information the corporation possesses, i.e., pricing structures, profit margins and mark-up information for various products.

After a few years of phenomenal performance, the sales manager, without warning, suddenly resigns and announces that he will be working for a major competitor in the same position. At the time of his resignation, there is pending a potentially major sale which the sales manager and a junior salesperson had been working for many months. Many hundreds of hours of design work, demonstrations, wining and dining, and much travel have gone into the sales proposal. The deal was very close to closing when the sales manager left the company.

A few days after the sales manager's departure, the customer contact for the potential major sale spoke to the junior sales person and demanded a price reduction which was very close to the company's mark-up figure on the proposed sale of the equipment. The customer contact made clear that without the requested reduction, there would be no sale.

C) The Entrepreneur Within

A small environmental testing and consulting business employs only ten people. Because the company is very busy but small, each employee wears several hats. One such person, a project manager, sells consulting services and oversees actual testing, but lacks the necessary qualifications and license in order to satisfy state regulators. Thus, he cannot "sign off" on completed projects. This status is critical to the company and allows it to obtain high-end environmental consulting projects which are extremely profitable. There is some friction between the project manager and the company president since the president feels he must step in too often to finish projects.

The president decides to hire a new person. The company pays several thousand dollars to send the new person to school to obtain the requisite license. In the meantime, the new person

is trained in all other aspects of the business by the unlicensed project manager. They become close friends through this work association.

The unlicensed project manager is also its informal "IT" manager. Each week he updates the company's computer files which contain its client lists, vendor information and pricing schedules, as well as all its financial information, including the salaries of all employees. The project manager does this work at home using a laptop supplied by the company.

One day after work the project manager and the new person are having drinks. The new person has now received her license and is working out well. The project manager tells the new person he is planning on leaving to start his own environmental consulting business. He shows her a business plan and stationary, new business cards, etc. that he has already made up. He tells her he needs her ability to sign off on projects and can offer her more money. She agrees to go with him. The next day they both submit their resignations.

NB. Each one of these scenarios is drawn from an actual case prosecuted by the author on behalf of the former employer. The legal actions taken, as well as the outcomes of same, appear at Section XI, *infra*.

### III. SOME PRINCIPLES GOVERNING EMPLOYEE DUTY OF LOYALTY

Historically, the public interest has favored free trade and the ability of employees to engage in competition by moving about at will. See *e.g.*, *Nordenfeldt v. Maxim Nordenfelt Guns & Ammunition Co.*, [1894] A.C. 535 at 565 ("[t]he public have an interest in every person's carrying on his trade freely: so has the individual. All interference with individual liberty of action in trading, and all restraints of trade themselves, if there is nothing more, are contrary to public policy and therefore void. That is the general rule") cited in *Consolidated Engineering Services v. Hatfield*, pp. 3-4, Suffolk Superior Court, C.A. No. 03-2689, Business Litigation Session 2 (Botsford, J.)<sup>1</sup> See also *Restatement (Third) Unfair Competition* § 1, comment a ("[t]he freedom to engage in business

and to compete for the patronage of prospective customers is a fundamental premise of the free enterprise system.")

The at-will employee may plan to go into competition with his employer and may take active steps to do so while still employed. The at-will employee has no general duty to disclose such plans to his employer, either before or after he resigns. At-will employees may change employers freely. *Augat, Inc. v. Aegis, Inc.*, 409 Mass. 165, 172 (1991).<sup>2</sup>

Certain limits apply, however, to the conduct of at-will employees who wish to compete with their employers. Employees cannot appropriate their former employer's trade secrets and other confidential business information. They may not solicit their employer's customers while still working for the employer. *Id.* An at-will employee also may not act for his own future interests at the expense of his employer by using his employer's funds or other resources for personal gain, or otherwise engage in a course of conduct designed to hurt the employer. *Id.* at 173.<sup>3</sup> The Restatement (Second) of Agency provides a rule governing confidential information belonging to the employer:

Unless otherwise agreed, an agent is subject to a duty to the principal not to use or to communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency or in violation of his duties as agent, *in competition with or to the injury of the principal*, on his own account or on behalf of another, although such information does not relate to the transaction in which he is then employed, unless the information is a matter of general knowledge.

*Restatement (Second) of Agency* § 395 (1957) (emphasis added). Comment a to this section adds:

The relation of principal and agent permits and requires great freedom of communication between the principal and the agent; *because of this, the agent is often placed in a position to obtain information of great use in competing with the principal*. To permit an agent to use, for his own benefit or for the benefit of others in competition with the principal, information confidentially given or acquired by him in the performance of or because of his duties as agent would tend to destroy the freedom of communication which should exist between the principal and the agent.

Before terminating employment, managerial personnel may not solicit the departure of employees – particular key employees – to work for a competitor. Doing so is a violation of management's duty of loyalty to the corporation. *Id.* at 173. See also *Chelsea Industries, Inc. v. Gaffney, et. al.*, 389 Mass. 1, 11-12 (1983) ("[b]ecause he is bound to act solely for his employer's benefit in all matters within the scope of his employment ... an executive employee is 'barred from actively competing with his employer *during* the tenure of his employment, even in the absence of an express covenant so providing ....'" (emphasis in the original) (citations omitted). Compare *Restatement (Second) of Agency* § 393, comment e ("[A] court may find that it is a breach of duty for a number of key officers or employees to leave their employment simultaneously ...")<sup>4</sup>

#### IV. TRADE SECRETS AND CONFIDENTIAL BUSINESS INFORMATION

In keeping with the historical emphasis on promoting market competition, an employee is free to "carry away and use the general skill or knowledge acquired during the course of employment." *Dynamics Research Corp. v. Analytic Sciences Corp.*, 9 Mass. App. Ct. 254, 269 (1980). He may not, however, compete with his former employer by using the trade secrets or other confidential business information of his former employer. *Richmond Brothers, Inc. v. Westinghouse Broadcasting Company, Inc.*, 357 Mass. 106, 111 (1970).<sup>5</sup> The term "trade secret" has been defined variously as follows:

A trade secret may consist of any formula, pattern, device or compilation of information which is used in one's business, and which gives him [or her] an opportunity to obtain an advantage over competitors who do not know or use it.

*J.T. Healy & Son v. James A. Murphy & Son*, 357 Mass. 728, 736 (1970) citing *Restatement of Torts* § 757, comment b (1939). A more recent statement of the law in this area does away with the "used in one's business" requirement, thereby providing a broader, more functional definition:

A trade secret can consist of a formula, pattern, compilation of data, computer

program, device, method, technique, process, or other form or embodiment of economically valuable information. A trade secret can relate to technical matters such as the composition or design of a product, a method of manufacture, or the know-how necessary to perform a particular operation or service. A trade secret can also relate to other aspects of business operations such as pricing and marketing techniques or the identity and requirements of customers.

*Restatement (Third) Unfair Competition* § 39, comment d (1995). The term "trade secret" is defined in the Massachusetts General Laws as "anything tangible or intangible or electronically kept or stored, which constitutes, represents, evidences, or records a secret scientific, technical, merchandising, production, or management information, design, process, procedure, formula, invention or improvement." G. L. c. 266, § 30(4) (a statute imposing criminal liability for trade secret theft.) See also e.g., *Peggy Lawton Kitchens, Inc. v. Hogan*, 18 Mass. App. Ct. 937 (1984) (chaff from walnuts added to chocolate chip cookie mix to produce "distinctive flavor" constituted trade secret.)

Business information which does not rise to the level of a "trade secret" *per se*, yet which may be protected as proprietary, includes specific business plans, financials, contract bid amounts, plans for expansion, customer lists, customer routes and the like. Some of the information at issue in the case scenarios in Section II, *supra*, for example, included the following: customer lists and leads; product pricing and profit margins on specific products; the status of specific bids and sales proposals; financial information and customer profiles and specific customer needs. The *sine qua non* of such proprietary information is secrecy. *Restatement (Third) Unfair Competition* § 39, comment f (1995) ("the requirement of secrecy is satisfied if it would be difficult or costly for others who could exploit the information to acquire it without resort to the wrongful conduct ....")<sup>6</sup>

The following criteria have been used to determine whether business information qualifies as a trade secret or otherwise should be treated as confidential and proprietary:

- 1) the extent to which the information is known outside the particular

business at issue;

- 2) the extent to which the information is known to employees and others within the company itself;
- 3) the extent of the measures taken by the company to guard the secrecy of the information;
- 4) the value of the information to the company;
- 5) the amount of effort or money expended in developing the information;
- 6) the ease or difficulty with which the information could be properly acquired or duplicated by others.

*Jet Spray Cooler, Inc. v. Crampton*, 361 Mass. 835, 840 (1972).<sup>7</sup> "[T]he subject matter of a trade secret must be secret. Matters of public knowledge or of general knowledge in an industry cannot be appropriated by one as secret." *Restatement of Torts* § 757, comment b. In particular circumstances, however, "routine data" belonging to a particular company may be considered confidential. For instance, information such as a company's sales locations may appear public and non-confidential; however, "whether and to what extent a [certain] location is profitable is highly confidential." *United Rug Auctioneers, Inc. v. Arsalen, et. al.*, Massachusetts Superior Court, C.A. No. 03-0347.<sup>8</sup>

Perhaps the most enduring judicial statement on the protection of business information not rising to the level of a technical trade secret can be found in *USM Corporation v. Marson Fastener Corporation, et. al.*, 379 Mass. 90, 104 (1979):

A plaintiff who may not claim trade secret protection either because it failed to take reasonable steps to preserve its secrecy or because the information, while confidential, is only "business information," may still be entitled to some relief against one who improperly procures such information. The law puts its imprimatur on fair dealing, good faith, and fundamental honesty. Courts condemn conduct which fails to reflect these minimum accepted moral values by penalizing such conduct whenever it occurs. *Seismograph Serv. Corp. v.*

*Offshore Raydist, Inc.*, 135 F. Supp. 342, 354-355 (E.D. La. 1955), modified on other grounds, 263 F.2d 5 (5<sup>th</sup> Cir. 1958) ("It is simply the difference between right and wrong, honesty and dishonesty, which is the touchstone in an issue of this kind.")... See also *Crocan Corp. v. Sheller-Globe Corp.*, 385 F. Supp. 251, 254-255 (N.D. Ill. 1974) ("Improper means used to gain information is a separate basis of liability, regardless of whether the information constitutes a technical trade secret").

See also *Restatement of Torts* § 759, comment b (1939) ("Examples of [confidential information], other than trade secrets,...are: the state of one's accounts, the amount of his bid for a contract, his sources of supply, his plans for expansion or retrenchment, and the like. *There are no limits as to the type of information included except that it relate to the matters in his business. Generally, however, ... the information must be of a secret or confidential character.*")

The *Restatement (Second) of Agency* § 396 (1957) offers the following general rule governing the use of confidential business information after the employee leaves his employer:

Unless otherwise agreed, after the termination of the agency, the agent:

- (a) has no duty not to compete with the principal;
- (b) *has a duty to the principal not to use or to disclose to third persons, on his own account or on account of others, in competition with the principal or to his injury, trade secrets, written lists of names, or other similar confidential matters given to him only for the principal's use or acquired by the agent in violation of duty. The agent is entitled to use general information concerning the method of business of the principal and the names of the customers retained in his memory, if not acquired in violation of his duty as agent;*
- (c) has a duty to account for profits made by the sale or use of trade secrets and other confidential information, whether or not in competition with the principal[.]

(Emphasis added.) See also *Merrill, Lynch, Pierce, Fenner & Smith, P.C. v. Morgan Dewey*, (Mass Super. 04-1005) (2004) (refusing to prohibit defendant ex-employee from soliciting employer's customers retained in his memory). The comment to Clause (b) of § 396, above, adds the following insights:

*The duty of an agent not to compete with the principal by using for his own purposes unique assets of the business, such as*

*trade secrets, which are frequently of great value as long as they remain secret, does not terminate with the employment. Such assets a former agent cannot properly use for his own purposes.*

(Emphasis added.) The comment to Clause (c) § 396 provides:

*Trade secrets and other similar private information constitute assets of the principal. Their subsequent use by a former agent is as improper as the use of other assets, and, whether or not the use is in competition, it is the basis for a restitution claim[.]*

(Emphasis added.) The secrecy necessary to adequately protect trade secrets need not be absolute. "Reasonable precautions to protect the secrecy of a trade secret will suffice." *Pioneer Hi-Bred International v. Holden Foundation Seeds, Inc., et. al.*, 35 F.3d 1226, 1235 (8<sup>th</sup> Cir. 1994).

Trade secret owners are not required to "guard against the unanticipated, the undetectable, or the unpreventable methods of espionage now available," or create "an impenetrable fortress." *E.I. duPont deNemours & Co. v. Christopher*, 431 F.2d 1012, 1016-1017 (5<sup>th</sup> Cir. 1970). See also *K-2 Ski Co. v. Head Ski Co.*, 506 F.2d 471, 473 (9<sup>th</sup> Cir. 1974) (describing steps taken to protect details on design and manufacture of skis).

#### V. THE PRELIMINARY STEPS DOCTRINE: LIABILITY'S BRIGHT LINE OR TRIP-LINE?

What steps, if any, may an employee take in preparation to compete with his current employer? Section 393 of the *Restatement (Second) of Agency* (1957) offers the following precepts:

*Unless otherwise agreed, an agent is subject to a duty not to compete with the principal concerning the subject matter of his agency.*

See *Restatement (Second) of Agency* § 393 (1957). Comment e to section 393 provides:

*Even before the termination of the agency [the employee] is entitled to make arrangements to compete, except that he cannot properly use confidential information peculiar to his employer's business and acquired therein. Thus, before the end of his employment, he can properly purchase a rival business and upon termination of employment immediately compete. He is not, however, entitled to solicit customers for such rival business before the end of his employment*



*nor can he properly do other similar acts in direct competition with the employer's business.*

See *Restatement (Second) of Agency* § 393, comment e (emphasis added). What "arrangements," then, may an employee make lawfully in preparation to compete? The answer is not always clear. In *Maryland Metals, Inc. v. Metzner, et. al.*, 282 Md. 31 (1978) the Maryland Court of Appeals faced the following issue head-on: "[T]he extent to which officers and high-level managerial employees may, prior to termination of the employment relationship, make preparations to compete with their corporate employer without violating fiduciary obligations running to the corporation." The *Maryland Metals* court recognized the inherent tension between the employee's freedom to pursue competitive endeavors and the employer's right to expect and receive undivided loyalty:

Admittedly the mere decision to enter into competition will eventually prove harmful to the former employer but because of the competing interests of allowing an employee some latitude in switching jobs and at the same time preserving some degree of loyalty owed to the employer the mere entering into competition is not enough. It is something *more than preparation* which is so harmful as to *substantially hinder* the employer in the continuation of his business.

*Maryland Metals, Inc.*, 282 Md. at 39-40, citing *Cudahy Company v. American Laboratories, Inc.*, 313 F. Supp. 1339, 1346 (D. Neb. 1970) (emphasis added). In *Maryland Metals*, two high-ranking employees of a scrap metal business – one an officer of the corporation – undertook in secret extensive preparations to establish a competing business. The concept for the competing enterprise had been discussed between the corporation's president and the employees, but had never come to fruition. Specifically, the two employees did the following while still working for Maryland Metals: 1) formed a new corporation; 2) negotiated with a potential investor; 3) applied for a bank loan to finance the new venture; 4) purchased a specialized metal shredding machine which they had analyzed for Maryland Metals; 5) purchased land for the new business which Maryland Metals had once considered buying; and 6) consulted with various vendors and

suppliers. At no time did the employees reveal these activities to their employer. In fact, they took active steps to conceal their preparatory dealings. There was no evidence, however, that either employee's job performance suffered as a result of the extensive plans to compete. In fact, each employee's performance remained exemplary throughout the preparations period.

The Maryland Court of Appeals found that the employees violated no obligations to their employer, despite having made such extensive preparations to leave and compete directly with it:

We hold that [the employees'] conduct here falls within the mere preparation privilege accorded employees contemplating termination of employment. Looking beyond the mere failure to disclose the details of their preparations, we have been unable to find in the record any evidence of such unfair, fraudulent or wrongful conduct on the part of [the employees] as would entitle [the employer] to relief in the form of an injunction, damages or an accounting for profits.

*Maryland Metals, Inc.*, 282 Md. at 48. The *Maryland Metals* court did point out that "[t]he right to make arrangements to compete is by no means absolute and the exercise of the privilege may, in appropriate circumstances, rise to the level of a breach of an employee's fiduciary duty of loyalty."

*Maryland Metals, Inc.*, 282 Md. at 40. The Court of Appeals offered several examples of conduct which will defeat the privilege: misappropriation of trade secrets; misuse of confidential information; solicitation of the employer's customers prior to cessation of employment; conspiracy to bring about mass resignation of employer's key employees; and usurpation of the employer's business opportunities. *Maryland Metals, Inc.*, 282 Md. at 40-41. See also *C-E-I-R, Inc. v. Computer Dynamics Corporation, et. al.*, 229 Md. 357, 367 (1962) ("[t]here would appear to be no precise line between acts by an employee which constitute mere preparation and those which amount to solicitation"); *E.J. McKernan Company, et. al. v. Gregory*, 252 Ill. App. 3d 514, 529 (1993) ("[c]orporate officers owe a fiduciary duty of loyalty to their employer not to: (1) actively exploit their positions within the corporation for their own personal benefit; or (2) hinder the ability of the corporation to conduct the business for which it was developed"); *Bancroft-Whitney Company v.*

*Glen*, 411 P.2d 921, 935 (1966) ("[n]o ironclad rules as to the type of conduct which is permissible can be stated, since the spectrum of activities in this regard is as broad as the ingenuity of man itself").

In stark contrast to the behavior of the employee-defendants in *Maryland Metals* was that of the executives in *Chelsea Industries, Inc. v. Gaffney*, 389 Mass. 1 (1983). In *Chelsea Industries*, the executive defendants unlawfully prepared to compete with their present employer by: (1) traveling to the company's foreign plant at company expense to photograph its plans and manufacturing machinery for the competing venture; (2) visiting and entertaining at company expense their employer's major customers and sales personnel in order to "cultivate close personal relationships ... to assist them in taking away business from [their employer] when their own competing business became operational;" and, (3) using confidential company sales information to assess the future sales potential of the competing venture. *Chelsea Industries, Inc. v. Gaffney*, 389 Mass. at 6-7. The *Chelsea Industries* court actually ordered the disloyal executives to pay back part of their employee compensation as a sanction for their blatantly illegal behavior – a remedy known as equitable forfeiture.

Notably, some courts have held that an employee's resignation alone may not relieve him of his fiduciary obligations to his former employer. In *T.A. Pelsue Company v. Grand Enterprises, Inc., et. al.*, 782 F. Supp. 1476 (D. Colo. 1991), the district court made the following observation:

Resignation or termination does not automatically free a director or employee from his or her fiduciary obligations. A former director breaches his or her fiduciary duty if he or she engages in transactions that had their inception before the termination of the fiduciary relationship of that were based on information obtained during that relationship

*T.A. Pelsue Company*, 782 F. Supp. at 1485. "Fairness dictates that an employee not be permitted to exploit the trust of his employer so as to obtain an unfair advantage in competing with the employer in a matter concerning the latter's business." *Kademenos v. Equitable Life Assurance*

Soc. of U.S., 513 F.2d 1073, 1076 (3rd Cir. 1975); Restatement (Second) of Agency § 387, comment b (1957).

## VI. THE UNIFORM TRADE SECRETS ACT: A PANACEA AT LAST?

Thirty-four states have adopted the Uniform Trade Secrets Act ("UTSA"). "Like traditional trade secret law, the Uniform Act contains general concepts. The contribution of the Uniform Act is substitution of unitary definitions of trade secret and trade secret misappropriation...." Uniform Laws Annotated (West). The UTSA defines a trade secret as:

[I]nformation, including a formula, pattern, compilation, program, device, method, technique, or process, that: (i) derives independent economic value, *actual or potential*, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use, and (ii) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.

Uniform Trade Secrets Act, section 1(4) (1985 amendments) (emphasis added). The official comment to this section points out that "proper means" may include independent discovery, "reverse engineering," and observation of items in public use. The official comment also explains that the Uniform Act provides a broader definition of "trade secret" than did the Restatement of Torts (First) which required that a trade secret be "continuously used in one's business." Thus:

The broader definition [of "trade secret"] ...extends protection to a plaintiff who has not yet had an opportunity or acquired the means to put a trade secret to use. The definition includes information that has commercial value from a negative viewpoint, for example the results of lengthy and expensive research which proves that a certain process will *not* work could be of great value to a competitor.

See Official Comment to UTSA, Section 1 (emphasis in original). The comment makes the further observation that:

The efforts required to maintain secrecy are those "reasonable under the circumstances." The courts do not require that extreme and unduly expensive procedures be taken to protect trade secrets against flagrant industrial espionage. ... It follows that reasonable use of a trade secret including controlled disclosure to employees and licensees is consistent

with the requirement of relative secrecy.

Official Comment, USTA Section 1. See Volume 14, *Uniform Laws Annotated, Uniform Trade Secrets Act*, pp. 438-439 (West). The USTA allows for injunctive relief in cases of "[a]ctual or threatened misappropriation." USTA, Section 2. The general principle here "is that an injunction should last for as long as necessary ... to eliminate the commercial advantage or 'lead time' with respect to good faith competitors that a person has obtained through misappropriation." Official Comment, USTA Section 2. *Id.* at 450. The USTA allows for an award of attorneys fees in instances of "willful and malicious misappropriation." See USTA, Section 4. *Id.* at 459. The Uniform Act also allows for up to twice actual damages. See USTA, Section 3. This section provides:

In lieu of damages measured by any other methods, the damages caused by misappropriation may be measured by imposition of liability for a *reasonable royalty* for a misappropriator's unauthorized disclosure or use of a trade secret.

USTA, Section 3 (emphasis added). *Id.* at 456. The Official Comment to this section states:

As an alternative to all other methods of measuring damages caused by a misappropriator's past conduct, a complainant can request that damages be based upon a demonstrably reasonable royalty for a misappropriator's unauthorized disclosure or use of a trade secret. In order to justify this alternative measure of damages, there must be competent evidence of the amount of a reasonable royalty.

Official Comment, USTA Section 3. *Id.* at 456. Under the USTA, the term "misappropriation" is quite extensive and somewhat formulaic. Consequently, common law jurisdictions may take a more flexible approach to finding violations of employee duty of loyalty relative to trade secrets.

## VII. EMPLOYMENT AGREEMENTS WITH RESTRICTIVE COVENANTS

Restrictive covenants in written employment contracts are judicially enforceable if the employer can demonstrate that:

- 1) the agreement is necessary to protect a legitimate business interest  
of the employer;

- 2) supported by consideration;
- 3) reasonable in scope;
- 4) is consistent with the public interest.

*All Stainless, Inc. v. Colby*, 364 Mass. 773, 778 (1973).<sup>9</sup> Examples of non-disclosure (i.e., confidentiality), non-solicitation, and non-competition covenants in written employment agreements which have been upheld in recent Massachusetts Superior Court decisions are attached hereto in Appendix C. A recent Massachusetts Superior Court decision enforced a non-competition clause in a written employment agreement providing for a twenty-four month restriction on ex-employees' would-be competing activities. See *United Rug Auctioneers, Inc. v. Arsalen, et. al.*, Superior Court Civil Action No. 03-0347 (Brady, J.)

The benefits of a written agreement are, *inter alia*, that it puts employees on notice as to which aspects of the business the employer considers proprietary, confidential or otherwise a part of the goodwill of the company. Moreover, a written employment agreement with restrictive covenants provides a valuable framework for a civil complaint should the need arise for same. For instance, such an agreement may stipulate that unauthorized disclosure of trade secrets and confidential information will result in irreparable harm to the company, an essential element for injunctive relief in duty of loyalty cases. See e.g., *Stone Legal Resources Group, Inc. v. Glebus, et. al.*, 2002 Mass. Super. LEXIS 555.

Legitimate business interests which may properly be the subject of restrictive covenants in written employment agreements include protection of trade secrets, confidential information, and business goodwill. Goodwill is defined as a business's positive reputation with its customers or potential customers generated by repeat business with existing customers or by referrals to potential customers. *Kroeger v. The Stop & Shop Companies, Inc.*, 13 Mass. App. Ct. 310, 316 (1982). Goodwill may also be shown by demonstrating particular expertise in a defined area, as

well as significant advertising. *Marine Contractors Co., Inc. v. Hurley*, 365 Mass. 280, 287 (1974); *Slate Co. v. Bikash*, 343 Mass. 172, 175 (1961).<sup>10</sup> "[P]rotection of the employer from ordinary competition ... is not a legitimate business interest, and a covenant not to compete designed solely for that purpose will not be enforced." *Marine Contractors*, 365 Mass at 287.

Practicing physicians and attorneys, as a matter of public policy, are not subject to the strictures of non-competition agreements. See e.g., G.L. c. 112, § 12X; *Meehan v. Shaughnessy*, 404 Mass. 419, 431 (1989) ("...a lawyer may not participate in an agreement which restricts the right of a lawyer to practice law after the termination of a relationship created by the agreement. One reason for this rule is to protect the public... The strong public interest in allowing clients to retain counsel of their choice outweighs any professional benefits derived from a restrictive covenant.") (Citations omitted.)

#### VIII. WHO NEEDS A RESTRICTIVE COVENANT? THE "INEVITABLE DISCLOSURE" DOCTRINE AND THE JUDICIALLY CREATED NON-COMPETE "AGREEMENT"

The absence of a written employment agreement with restrictive covenants may not be fatal to the cause of an employer trying to prohibit proprietary and confidential business information from being used by an ex-employee to compete unfairly. In some jurisdictions courts have fashioned restrictive employment agreements *ex post facto* where clear violations of employee duty of loyalty have been demonstrated. An excellent example of such judicial intervention is found in *DoubleClick v. Henderson, et. al.*, 1997 N.Y. Misc. Lexis 577. (See Appendix D for full text of opinion.)

DoubleClick was a new, fast-growing Internet advertising business. The company had two types of clients: 1) a network of 75 popular web sites with respect to which it had an agreement to sell advertising space on the sites, and 2) individual advertisers who had separate contracts with

DoubleClick which allowed them to shown their ads on the web site network without having to negotiate access to each web site.

DoubleClick had developed proprietary methods of delivering ads to the web sites in its network, as well as systems which caused certain ads to "pop up" when specified search terms were used. The company also developed proprietary methods to gauge the effectiveness of its advertisements. The company maintained various sources of proprietary information such as sales and marketing strategies, customer requirements, financial projections, and a business plan which discussed long-term goals and strategies.

Two top managers with access to all of the above-described company information decided to leave DoubleClick and start their own competing business. They began preparations to do so while still employed at the company. When DoubleClick learned of their plans, it fired both managers and confiscated their laptops, where, it discovered a competing business plan and other strategic documents. It promptly went to court to enjoin the competing business. *It should be noted that neither ex-manager had signed a confidentiality agreement or non-compete which pertained to their employment with DoubleClick.*

DoubleClick asserted the following counts in its complaint against the ex-managers and their new competing venture: misappropriation of trade secrets, unfair competition, and breach of duty of loyalty. The court found that the two former executives had in fact misappropriated DoubleClick's trade secrets. In particular, the court noted that one of the executives had on his laptop a document showing the company's margins or "site share," i.e., the percentage shares which it and a client web site split from advertising revenue. It appeared that the former executives intended to use this information to offer "better" deals to DoubleClick's clients.

The court also found that "the centrality of [the executives] in DoubleClick's operations makes it unlikely that they could eradicate" the trade secrets from their minds in the context of the



competing venture. With regard to duty of loyalty issues, the court noted the following: the executives had used DoubleClick's computers, e-mail and spread sheets to build their own competing business plan. The executives – while still employed by DoubleClick – had also met with a potential DoubleClick client, pitched the client for DoubleClick, and then, immediately thereafter, pitched the prospective DoubleClick client for their new venture.

In agreeing to fashion equitable relief in favor of DoubleClick, the court found the following preliminary facts which constituted liability for misappropriation of trade secrets, breach of duty of loyalty, and unfair competition:

[T]here is substantial evidence that defendants 1) used DoubleClick's proprietary information to prepare for the launch of [the competing venture] and to position it to compete with DoubleClick, 2) worked on their plans for their new company during working hours at DoubleClick and used resources given to them by Double Click to do so, and 3) sought customers and financing for [the competing venture] without regard to their duties to their current employer. (*DoubleClick*, page 7.)

The court fashioned the following remedy which in effect amounted to a judicially imposed non-compete/non-disclosure agreement, although none existed between DoubleClick and the ex-managers prior to suit:

Defendants are enjoined, for a period of six months from the date of this opinion, from launching any company, or taking employment with any company, which competes with DoubleClick, where defendants' job description(s) or functions at said company or companies include providing any advice or information concerning any aspect of advertising on the Internet...

....

Defendants are also enjoined, for a period of six months from the date of this opinion, from providing any advice or information concerning any aspect of advertising on the Internet to any third parties who 1) work for defendants' employer(s), or 2) provide or promise to provide any of the defendants with valuable consideration for the advice or information, or 3) share or promise to share any financial interest with any of the defendants. (*DoubleClick*, page 8.)

An excellent leading statement of the inevitable disclosure doctrine is found in *PepsiCo, Inc. v. Redmond, et. al.*, 54 F.3d 1262 (7<sup>th</sup> Cir. 1995). In *PepsiCo*, the employee signed a

confidentiality agreement at the beginning of his employment, but not a non-compete. The employee's managerial position made him privy to PepsiCo's national and regional sports drink marketing strategies for the upcoming year. He was recruited for an equally high-level position by a direct competitor, Quaker Oats. In affirming the district court's grant of a preliminary injunction, the Court of Appeals effectively converted the ex-employee's confidentiality agreement into a non-compete, by preventing the ex-employee from working with the direct competitor for a period of six months. In so doing, the Court of Appeals found:

[U]nless [the former employee] possessed an uncanny ability to compartmentalize information, he would necessarily be making decisions about Gatorade and Snapple by relying on his knowledge of [PepsiCo's] trade secrets. It is not the "general skills and knowledge acquired during his tenure with" PepsiCo that PepsiCo seeks to keep from falling into Quaker's hands, but rather *"the particularized plans or processes developed by [PepsiCo] and disclosed to him while the employer-employee relationship existed, which are unknown to others in the industry and which give the employer an advantage over his competitors."*

*PepsiCo.*, 54 F.3d at 1269 (emphasis added) (citations omitted). The Court of Appeals also pointed out: "PepsiCo finds itself in the position of a coach, one of whose players has left, playbook in hand, to join the opposing team before the big game." *Id.* at 1270. See also *Lumex, Inc. v. Highsmith*, 919 F. Supp. 624, 631 (E.D.N.Y. 1996) ("there is not only a high risk, but it is inevitable that [defendant ex-employee] will disclose important Cybex trade secrets and confidential information in his efforts to improve the Life Circuit product, and aid his new employer and his own future.")

The inevitable disclosure doctrine has been soundly criticized. Some courts have argued that its application should be limited to instances of "overt theft of trade secrets and breaches of fiduciary duty." *EarthWeb, Inc. v. Schlack*, 71 F. Supp.2d 299, 310 (S.D.N.Y. 1999). The *EarthWeb* court also noted several specific problems with the doctrine's application:

[I]n cases that do not involve the actual theft of trade secrets, the court is essentially asked to bind the employee to an implied-in-fact restrictive covenant based on a finding

of inevitable disclosure.

....

Thus, in its purest form, *the inevitable disclosure doctrine treads an exceedingly narrow path through judicially disfavored territory*. Absent evidence of actual misappropriation by an employee, the doctrine should be applied in only the rarest of cases. *Factors to consider in weighing the appropriateness of granting injunctive relief are whether: (1) the employers in question are direct competitors providing the same or very similar products or services; (2) the employee's new position is nearly identical to his old one, such that he could not reasonably be expected to fulfill his new job responsibilities without utilizing the trade secrets of his former employer; and (3) the trade secrets at issue are highly valuable to both employers.*

While the inevitable disclosure doctrine may serve the salutary purpose of protecting a company's investment in its trade secrets, *its application is fraught with hazards*. Among these risks is the imperceptible shift in bargaining power that necessarily occurs upon the commencement of an employment relationship marked by the execution of a confidentiality agreement. When that relationship eventually ends, the parties' confidentiality agreement may be wielded as a restrictive covenant, depending on how the employer views the new job its former employee has accepted. This can be a powerful weapon in the hands of an employer; the risk of litigation alone may have a chilling effect on the employee. Such constraints should be the product of open negotiation.

*EarthWeb, Inc.*, 71 F.Supp.2d at 310 (emphasis added). Thus, the inevitable disclosure doctrine may not always be available to provide relief other than in the most egregious of cases.

Some common law jurisdictions will grant injunctions to protect confidential and proprietary business information absent express agreements governing same. The justification for doing so rests on a theory of implied contract arising from the employer/employee relationship. See e.g., *Woolley's Laundry, Inc. v. Silva*, 304 Mass. 383, 386 (1939) ("[o]ut of the mere general relationship of employer and employee certain obligations arise, including that which precludes an employee from using, for his own advantage or that of a rival and to the harm of his employer, confidential information that he has gained in the course of his employment.")

For example, in *New England Overall Co., Inc. v. Woltmann, et. al.*, 343 Mass. 69, 75 (1961) the plaintiff hired the defendant as its sales manager. Defendant was the first person outside of the family which owned the business "to have access to its innermost secrets." *Id.* at 72.

Specifically, the defendant Woltmann was privy to customer lists, supplier information, sales projections, costs and inventory information. *Id.* Defendant held this position for seven years until he and another sales employee secretly decided to compete with the plaintiff. Toward that end, Woltmann bought in his own name from the plaintiff's suppliers certain merchandise of the same design which plaintiff planned to introduce as part of its spring and summer clothing line. *Id.* at 73. Defendant did so intending to sell the merchandise to plaintiff's customers through a competing venture. The defendants – while still employed by plaintiff – also incorporated a competing entity through which they purchased additional merchandise from plaintiff's suppliers. A few months later both defendants resigned within ten days of each other. *Id.* at 74.

The Supreme Judicial Court recited the findings of the master appointed to hear the case:

Shortly thereafter, the plaintiff learned that many of the confidential items and listings relating to customers and suppliers of the plaintiff were missing. The master found that Woltmann had taken them; and that Woltmann and [the other sales employee] were soliciting ...both customers and suppliers of the plaintiff. *They had obtained from the suppliers merchandise of a manufacture, style, and pattern which could not be distinguished from that sold by the plaintiff without careful examination, and were selling it at cut prices* which tended to destroy the plaintiff's trade reputation and good will established over many years. The master found that *it was difficult to ascertain the damage which has been done and will be done to the plaintiff's good will and reputation by the defendants' price cutting* and efforts to induce customers and suppliers to "break away" from the plaintiff.

*Id.* at 74. (Emphasis added.) The Court affirmed an injunction which prohibited the defendants from communicating with plaintiff's customers in the New England States as well as Pennsylvania, despite the fact that Woltmann had no written employment contract with plaintiff. "In situations where there has been no express contract of an employee not to use or disclose confidential information entrusted to him during his employment, this court has held that ... he may be enjoined from using or disclosing confidential information so acquired." *New England Overall Co., Inc. v. Woltmann, et. al.*, 343 Mass. 69, 75 (1961).<sup>11</sup>

**IX. WHO TO SUE: SHOULD YOU TARGET THE NEW EMPLOYER ALONG WITH THE EX-EMPLOYEE, OR AVOID MAKING A MOUNTAIN OF A POTENTIAL MOLE HILL?**

In employee duty of loyalty cases there may be claims against the new employer. The new employer may be held liable for misappropriation of trade secrets, as long as the new employer has notice of the ex-employee's nefarious activities in this respect. See e.g. *Curtiss-Wright Corporation v. Edel-Brown Tool & Die Co.*, 381 Mass. 1, 5-6 (1980).<sup>12</sup> The new employer may be liable for aiding and abetting breach of the ex-employee's fiduciary duties to his ex-employer. See e.g., *Spinner v. Nutt*, 417 Mass. 549, 556 (1994) ("[a]lthough liability arises when a person participates in a fiduciary's breach of duty ... the plaintiff must show that the defendant knew of the breach and actively participated in it such that he or she could not reasonably be held to have acted in good faith.") An action may also lie for intentional interference with contractual or advantageous business relations. See *Swanset Development Corp. v. Taunton*, 423 Mass. 390, 397 (1996).

There are practical considerations when targeting the new employer. For instance, a suit against the new employer may invite counterclaims (such as restraint of trade, G.L. c. 93, § 5, and abuse of process), as well as a harder-fought battle than desired. The new employer may bankroll the defense of the ex-employee. Moreover, it may be more difficult to limit or prevent the involvement of one's own customers in the litigation, particularly where the new employer may have solicited them independent of and prior to hiring the ex-employee.

As word and rumors of the litigation spread among customers, some may be "turned off" by what they perceive to be overly aggressive business tactics designed to stifle competition, or simply "sour grapes." Moreover, it may be easier to negotiate a compromise with the new employer concerning the status of the ex-employee and any confidential information he may possess if the new employer is not targeted directly as a defendant. Of course, because equity (in the form of

injunctive relief) operates *in personam*, it may not be possible to obtain the full measure of relief and protection absent claims against the ex-employee's new company or venture.

**X. A LIKELIHOOD OF SUCCESS ON THE MERITS: THE "SILVER BULLET" OF INJUNCTIVE RELIEF THAT MAY STOP DISLOYALTY IN ITS TRACKS**

Injunctive relief is particularly appropriate in cases involving the protection of confidential and proprietary business information and customer goodwill. "[T]he loss of goodwill has been recognized as being particularly hard to quantify, giving rise to the need for equitable relief." *Stone Legal Resources v. Glebus*, 2002 Mass. Super. LEXIS 555, p. 8. As was noted in *Jillian's Billiard Club of America, Inc. v. Beloff Billiards, Inc.*, 35 Mass. App. Ct. 372, (1993):

Injunctive relief is often appropriate in trade secret cases to insure against additional harm to the trade secret owner from further unauthorized use of the trade secret and to deprive the defendant of additional benefits from its wrongful conduct. If the information has not become generally known, an injunction may also be appropriate to prevent destruction of the plaintiff's rights in the trade secret through a public disclosure by the defendant.

*Id.* at 376, citing *Restatement of Unfair Competition* § 44(2) (Tent. Draft No. 4, 1993). See also *DoubleClick, Inc. v. Henderson, et al.*, 1997 N.Y. Misc. LEXIS 577. ("[D]efendants' exploitation of their intimate knowledge of DoubleClick's proprietary information is impossible to quantify in dollar terms. Accordingly, an injunction is the appropriate remedy.")

The proponent of injunctive relief must demonstrate a likelihood of success on the merits of its substantive law claims; irreparable harm (*i.e.*, inadequacy of monetary damages in light of the goodwill interests at stake); that the balance of harms favors plaintiff rather than defendant; and that the public interest will be served by granting the requested relief. *Packing Indus. Group, Inc. v. Cheney*, 380 Mass. 609, 616, 617 (1980).<sup>13</sup>

**XI. MONETARY DAMAGES FOR MISAPPROPRIATION SHOULD BE CONSIDERED**

Damages for misappropriation of trade secrets and confidential information may be assessed as defendant's profits realized from his tortious conduct; plaintiff's lost profits; or a

reasonable royalty. "[W]hile a plaintiff is not entitled to a double recovery, 'the plaintiff is entitled to the profit he would have made had his secret not been unlawfully used, but not less than the monetary gain which the defendant reaped from his improper acts.'" *Jet Spray Cooler, Inc. v. Crampton*, 377 Mass. 159, 170 (1979). Multiple damages may also be awarded pursuant to statute. See e.g., G.L. c. 93, § 42 which provides in pertinent part:

Whoever embezzles, steals or unlawfully takes, carries away, conceals, or copies, or by fraud or by deception obtains, from any person or corporation, with intent to convert to his own use, any trade secret, regardless of value, shall be liable in tort to such person or corporation for all damages resulting there from. *Whether or not the case is tried by a jury, the court in its discretion, may increase the damages up to double the amount found.*

*Jet Spray Cooler, Inc. v. Crampton*, 377 Mass. 159, 167 n. 8 (1979) (emphasis added).<sup>14</sup>

See also *Analogic Corp. v. Data Translation, Inc.*, 371 Mass. 643, 649 (1976) ("defendants should not be permitted a competitive advantage from their avoidance of the normal cost of invention and duplication.") Despite the availability of money damages in duty of loyalty cases, injunctive relief nevertheless remains the quickest, most efficacious means of thwarting the machinations of would-be absconders of company proprietary information.

It is also worth noting that the federal Economic Espionage Act of 1996, 18 U.S.C. §§ 1831 – 1839, criminalized the theft or misappropriation of trade secrets for economic or commercial advantage. The Act defines a trade secret more broadly than does the UTSA:

[T]he term "trade secret" means all forms and types of financial, business, scientific, technical, economic, or engineering information, including patterns, plans, compilations, program devices, formulas, designs, prototypes, methods, techniques, processes, procedures, programs, or codes, whether tangible or intangible, and whether or how stored, compiled, or memorialized physically, electronically, graphically, photographically, or in writing if –

- (A) the owner thereof has taken reasonable measures to keep such information secret; and
- (B) the information derives independent economic value, actual or potential, from not being generally known to, and not being

In this case the plaintiff moved very quickly against the five former sales representatives. Although none had signed a formal non-compete, the court granted, *ex parte*, a Temporary Restraining Order against all five former salespersons which commanded in part that they:

[D]esist and refrain from using, concealing, revealing, divulging, assigning or disseminating any document or any information concerning or relating to plaintiff's business; and *further from pursuing rentals, sales or other real estate services with any clients with whom you had any contact while associated with the plaintiff and/or with respect to which you became aware of while associated with the plaintiff[.]*

(Emphasis added.) (See Appendix B for the entire Restraining Order text.) The court also ordered that the sales representatives return to the company "any books, records, or other documents given to or acquired by you from plaintiff and any documents containing information taken from any such documents...." Unfortunately for the salespeople, they had planned a large party to introduce their new endeavor, inviting primarily plaintiff's clients and contacts as guests. In light of the above order, however, the party had to be cancelled. By its terms the restraining order expired in 10 days. When the court, after hearing, indicated its inclination to grant a preliminary injunction more or less mirroring the restraining order, the parties worked out a settlement agreement.

#### B) The Flash-in the-Pan Departure

While employed by the plaintiff company, the sales manager had signed an "Employee Proprietary Information and Inventions Agreement" which provided in part:

I agree to keep confidential and not disclose, or make any use of except for the benefit of the Company ... any trade secrets or confidential information of the Company relating to products, processes, know-how, designs, formulas, test data, customer lists, business plans, marketing plans and strategies and pricing strategies....

Throughout his employment with the company, the sales manager was routinely provided with computerized customer lists and pricing information, including gross margin and distribution information. Distribution of this information was limited to a select few sales employees and company principals. At a hearing on Plaintiff's motion for preliminary injunction, the court indicated it was inclined



to grant the requested relief prohibiting the sales manager from calling on plaintiff's customers or otherwise using the confidential sales information of the company. With this in mind, the parties worked out a stipulated injunction which entered with the court's imprimatur.

**C) The Entrepreneur Within**

The departing project manager *had not signed a non-compete/confidentiality agreement with the plaintiff company*. Nevertheless, the plaintiff company sought and obtained an injunction prohibiting the ex-employee and his new company from taking affirmative steps to contact any of the former employers' clients for a period of one year. Also, the defendants returned dozens of CD's containing client lists and other proprietary information belonging to the plaintiff company.

**XIV. SUGGESTIONS FOR STAYING OUT OF TROUBLE**

Make written employment agreements containing restrictive covenants a part of the employment relationship *from the outset*.<sup>15</sup> Also, spell out the type of information considered to be confidential and proprietary by the employer.<sup>16</sup> Limit employee access to sensitive information used in the operation of the business, and put all employees on notice that certain kinds of information will be imparted to employees only on a need-to-know basis. Make sure employees understand that company property – including intellectual property – must be returned to the employer prior to departure. In particular, the use and whereabouts of items like sales manuals, training manuals and other writings discussing business plans and company processes should be routinely monitored. Even "lower level" employees may need to sign non-disclosure agreements if they work in and around highly sensitive business information or machinery.

- Notes to Text -

1. The *Nordenfeldt* passage continues: "But there are exceptions: restraints of trade and interference with individual liberty of action may be justified by the special circumstances of a particular case."

Massachusetts in essence adopted this proposition in *Sherman v. Pfefferkorn*, 241 Mass. 468, 474 (1922):

It clearly follows that Pfefferkorn was rightly enjoined from soliciting ... patronage of customers of the plaintiff, the names of whom had become known to him in the course of and by reason of his employment, and from disclosing the names or using, to the detriment of the plaintiff, information or knowledge regarding the ... business which had been confidentially gained by him in the course of his employment.

2. See also *Meehan v. Shaughnessy*, 404 Mass. 419, 435 (1989) ("fiduciaries may plan to compete with the entity to which they owe allegiance, 'provided that in the course of such arrangements they [do] not otherwise act in violation of their fiduciary duties.'") (Citation omitted.)

Consider *Restatement of Unfair Competition* § 42, comment b (1995):

During the duration of an employment relationship, an employee is subject to a duty of loyalty applicable to all conduct within the scope of the employment. See *Restatement, Second, Agency* § 387. The duty of loyalty encompasses a general duty not to compete with the employer in the subject matter of the employment ... including a duty to refrain from using confidential information acquired through the employment in competition with the employer.

3. For particularly egregious examples of the proscribed behavior exhibited by corporate officers and management employees see: *New England Overall Co., Inc., v. Woltmann, et. al.*, 343 Mass. 69, 75 (1961) where the corporate officer established and operated a competing business while still employed by corporation; *Chelsea Industries, Inc. v. Gaffney*, 389 Mass. 1 (1983) where corporate officers preparing to compete with employer continually subordinated employer's interest to that of prospective competing venture.
4. Other proscribed behavior of corporate officers may include: using paid work time to plan a competing venture; recommending salary increases and maximum bonuses for disloyal employees planning to leave with the officers; traveling at company expense to cement personal relationships with

employer's customers in order to secure customers for competing venture after departure. See e.g., *Chelsea Industries, Inc. v. Gaffney*, 389 Mass. 1, 11 (1983).

5. For more on this issue see *Richmond Brothers, Inc. v. Westinghouse Broadcasting Company, Inc., et. al.*, 357 Mass. 106, 111 (1970) citing *Club Aluminum Co. v. Young*, 263 Mass. 223, 226-227:

[A]n employer cannot by contract prevent his employee from using the skill and intelligence acquired or increased and improved through experience or through instruction received in the course of the employment. The employee may achieve superiority in his particular department by every lawful means at hand, and then, upon the rightful termination of his contract for service, use that superiority for the benefit of rivals in trade of his former employer.

"[A] man's aptitudes, his skill, his dexterity, his manual or mental ability ...ought not to be relinquished by a servant; they are not his master's property; they are his own property; they are himself." *Richmond Brothers, Inc.*, 357 Mass. at 111, citing *Herbert Morris, Ltd. v. Saxelby*, 1 [1916] A.C. 688, 714.

"Application of the rules protecting trade secrets in cases involving competition by former employees requires a careful balancing of interests. There is a strong public interest in preserving the freedom of employees to market their talents and experience in order to earn a livelihood. The mobility of employees also promotes competition through dissemination of useful skills and information." *Restatement of Unfair Competition* § 42, comment b (1995).

Compare *Aronson v. Orlov*, 228 Mass. 1, 5 (1917) ("[E]quity will enjoin interference with the right of a manufacturer to his own trade secrets ... There is a plain distinction between instances where employees leave one employer and use their own faculties, skill and experience in the establishment of an independent business or in the service of another, and instances where they use confidential information secured solely through their employment to the harm of their previous employer.")

6. "Indeed, the duty not to use confidential information is not limited to technical trade secrets." *Jet Spray Cooler, Inc. v. Crampton*, 361 Mass. 835, 839-840 (1972).

The *Restatement of Unfair Competition* § 39 comment g offers the following on precautions to maintain secrecy of confidential information:

Precautions to maintain secrecy may take many forms, including physical security designed to prevent unauthorized access, procedures intended to limit disclosure based upon the "need to know," and measures that emphasize to

recipients the confidential nature of the information such as nondisclosure agreements, signs, and restrictive legends.

7. See also *USM Corporation v. Marson Fastener Corporation, et. al.*, 379 Mass. 90, 101 (1979) ("We do not require the possessor of a trade secret to take heroic measures to preserve its secrecy.")

"The question whether a plaintiff has taken 'all proper and reasonable steps' depends on the circumstances of each case, considering the nature of the information sought to be protected as well as the conduct of the parties." *Id.* (Emphasis in the original.)

"It is not possible to state precise criteria for determining the existence of a trade secret. The status of information claimed as a trade secret must be ascertained through a comparative evaluation of all the relevant factors, including the value, secrecy, and definiteness of the information as well as the nature of the defendant's misconduct." *Restatement of Unfair Competition* § 39, comment d (1995).
8. For an example of reasonable steps taken by an employer to protect its trade secrets see *Eastern Marble Products Corp. v. Roman Marble, Inc., et. al.*, 372 Mass. 835, 840 (1977) ("Each manufacturing employee ... was required to sign an agreement not to disclose the methods and procedures involved in the manufacturing processes .... Such an agreement cannot be disregarded as an empty formality. At the very least it put the employees on notice that secrets were involved.")
9. "The consequence of every covenant not to compete ... is that the covenantor is deprived of a possible means of earning his living, within a defined area and for a limited time. That fact alone does not make such covenants unenforceable." *Marine Contractors Co., Inc., v. Hurley*, 365 Mass. 280, 289 (1974).
10. "The former employee must be in a position where he can harm that good will .... [P]erhaps ... because the former employee's close association with the employer's customers may cause those customers to associate the former employee, and not the employer, with products of the type sold to the customer through the efforts of the former employee." *All Stainless, Inc. v. Colby*, 364 Mass. 773, 779-780 (1974).
11. See also *Eastern Marble Products Corp. v. Roman Marble, Inc.*, 372 Mass. 835, 841 (1977) ("It is settled by our cases that the duty of an employee not to disclose confidential information is grounded on 'basic principles of equity' ... and upon an implied contract, growing out of the nature of the employer-employee relation.")

"The duties owed by the defendants to the plaintiff spring from the basic principles of equity as revealed in our own decisions which are in accord with the Restatement 2d: Agency. Section 396 states the proposition as follows:

'Unless otherwise agreed, after the termination of the agency, the agent: (a) has no duty not to compete with the principal; (b) has a duty to the principal not to use or to disclose to third persons, on his own account or on account of others, in competition with the principal or to his injury, trade secrets, written lists of names, or other similar confidential matters given to him only for the principal's use or acquired by the agent in violation of duty.'

*New England Overall Co., Inc. v. Woltmann, et. al.*, 343 Mass. 69, 76 (1961).

"The employment relationship by its nature ordinarily justifies an inference that the employee consents to a duty of confidence with respect to any information acquired through the employment that the employee knows or has reason to know is confidential ... The duty to refrain from unauthorized use or disclosure of confidential information continues after termination of the employment relationship." *Restatement of Unfair Competition* § 42, comment c (1995).

12. "It is true ... that one must have notice of both the fact that the information claimed to be a trade secret is in fact secret and the fact that disclosure by the third person is a breach of duty before one is subject to liability for the use or disclosure of the trade secret." *Curtiss-Wright Corporation v. Edel-Brown Tool & Die Co.*, 381 Mass. 1, 5-6 (1980).
13. "In determining whether a covenant will be enforced, in whole or in part, the reasonable needs of the former employer for protection against harmful conduct of the former employee must be weighed against both the reasonableness of the restraint imposed on the former employee and the public interest." *All Stainless, Inc. v. Colby*, 364 Mass. 773, 778 (1974).
14. A business-to-business 93A claim may allow for the same sanctions, costs, and attorneys fees if brought against the competing venture only. There is no such claim against the former employee under Chapter 93A. See e.g., *Informix, Inc. v. Rennell*, 41 Mass. App. Ct. 161, 163 (1996) ("Employment agreements between an employee and his employer do not constitute either 'trade' or 'commerce.'")
15. Some jurisdictions require that restrictive covenants entered into after the employment relationship begins must be supported by separate consideration. Continued employment alone may not be enough.

16. The non-disclosure provision of the employment agreement at issue in *Oxford Global Resources, Inc. v. Consolo*, Massachusetts Superior Court Civil Action No. 02-4763-BLS2 (2002) expressly defined "Confidential Information" as "...any and all information, ...concerning: ... (c) candidates and contractors, including lists, resumes, and related information; (d) the Company's customers and prospective customers, including their identity, special needs, job orders, preferences, transaction histories, contacts, characteristics, agreements and prices ...." *Id.* at n. 3.

## **CHAPTER 2**

**LATEST EFFORTS AT NON-COMPETE “REFORM”  
PENDING IN THE MASSACHUSETTS LEGISLATURE**

In July 2014, at the very end of the last full two-year legislative session, the Massachusetts Senate passed an economic development bill (S. 2241) which had buried deep within it a non-compete “reform” measure which would have made it much harder for employers to enforce such restrictive covenants. This was the first time since such reform efforts began approximately 7 years ago that any version actually passed one of the two legislative bodies on Beacon Hill. The House did not take up the non-compete reform portion of the economic development bill passed by the Senate. Therefore, the non-compete reform effort failed yet again. Part of the reform bill included the following section:

(d) Notwithstanding anything to the contrary in this section, a court may, in its discretion, reform an employee noncompetition agreement so as to render it valid and enforceable, provided, however, that a court may reform the duration, the scope of proscribed activities, and the geographic reach only if the provision to be reformed was either presumptively reasonable as set forth above or the employer made objectively reasonable efforts to draft the particular provision so that it would be presumptively reasonable as set forth above. Further, a court may decline to enforce some or all of the restrictions in an otherwise valid and enforceable employee noncompetition agreement where necessary to prevent injustice or an unduly harsh result, including those arising from the employee’s economic circumstances, or based on any other common law or statutory legal or equitable defense or doctrine.

This section would have made it nearly impossible to predict whether any given non-compete agreement between two private parties would be enforced in court should the signatories wind up there. What constitutes preventing “injustice” or an “unduly harsh result” in any given enforcement case is any one’s guess. Our courts already possess tremendous equitable powers in this respect. I recently had a non-compete enforcement case where the contract at issue called for a two year non-compete period, and an all-New England geographical scope. After hearing the evidence in the form of affidavits, the court enforced the non-compete against a former sales employee, but limited the period to one year, and cut the geographic scope back to one state



only. The court felt that these new parameters were enough to protect the goodwill of the business seeking full enforcement of the contract's terms.

In the current Legislative Session (2015 -2017), several "non-compete bills" have been filed and are now pending. One Senate version (S. 957; Docket No. 809), filed on January 15, 2015, provides for a complete proscription of non-compete covenants:

Any written or oral agreement arising out of an employment or independent contractor relationship that prohibits, impairs, restrains, restricts or places any condition on a person's ability to seek, engage in, or accept any type of employment or independent contractor work, for any period of time after an employment or independent contractor relationship has ended, shall, to that extent, be void and unenforceable.

S. 957, Lines 4 – 8. This language would effectively eliminate the use and enforcement of non-compete agreements in their entirety within the Commonwealth. The proposed statutory language would not affect "covenants not to solicit or transact business with actual or prospective customers, clients, or vendors of the employer[.]" Nor would it impose any restrictions on nondisclosure agreements or noncompetition agreements made in connection with the sale of a business, where the person subject to the restrictions is at least a ten percent owner "who received significant consideration for the sale[.]"

The House counterpart to S. 957 contains the exact same proscriptive language. H. 1701 was filed on January 15, 2015, as House Docket No. 2332. There is also pending in the House of Representatives a bill – H. 1761 – which provides that "any contract that serves to restrict an employee or former employee from engaging in a lawful profession, trade, or business of any kind is deemed unlawful." H. 1761, Lines 18 -20. This version also contains exceptions where the sale of a business is concerned. H. 1719 contains the same prohibition against non-competes.

Also pending this legislative session is S. 169 entitled, "An Act to protect trade secrets and eliminate non-compete agreements." (Senate Docket No. 334 filed January 14, 2015). The proposed legislation is a form of the Uniform Trade Secrets Act. Section 11 of the proposed

legislation contains the same language as S. 957 cited above which in essence puts an end to non-competes in Massachusetts. The proposed trade secrets act also contains several provisions which set much higher barriers for trade secret protection than does the uniform law which has been adopted in most states.

**SENATE . . . . . No. 957****The Commonwealth of Massachusetts**

PRESENTED BY:

***William N. Brownsberger***

*To the Honorable Senate and House of Representatives of the Commonwealth of Massachusetts in General Court assembled:*

The undersigned legislators and/or citizens respectfully petition for the adoption of the accompanying bill:

**An Act relative to the judicial enforcement of noncompetition agreements.**

PETITION OF:

| NAME:                          | DISTRICT/ADDRESS:                                 |                 |
|--------------------------------|---|-----------------|
| <i>William N. Brownsberger</i> | <i>Second Suffolk and Middlesex</i>               |                 |
| <i>Lori A. Ehrlich</i>         | <i>8th Essex</i>                                  |                 |
| <i>Jason M. Lewis</i>          | <i>Fifth Middlesex</i>                            |                 |
| <i>Kenneth J. Donnelly</i>     | <i>Fourth Middlesex</i>                           |                 |
| <i>John F. Keenan</i>          | <i>Norfolk and Plymouth</i>                       |                 |
| <i>Kathleen O'Connor Ives</i>  | <i>First Essex</i>                                |                 |
| <i>Brian A. Joyce</i>          | <i>Norfolk, Bristol and Plymouth</i>              |                 |
| <i>Michael J. Barrett</i>      | <i>Third Middlesex</i>                            |                 |
| <i>James B. Eldridge</i>       | <i>Middlesex and Worcester</i>                    |                 |
| <i>Anthony W. Petrucci</i>     | <i>First Suffolk and Middlesex</i>                |                 |
| <i>Patricia D. Jehlen</i>      | <i>Second Middlesex</i>                           |                 |
| <i>Daniel A. Wolf</i>          | <i>Cape and Islands</i>                           |                 |
| <i>Jennifer L. Flanagan</i>    | <i>Worcester and Middlesex</i>                    |                 |
| <i>Michael F. Rush</i>         | <i>Norfolk and Suffolk</i>                        |                 |
| <i>Barbara L'Italien</i>       | <i>Second Essex and Middlesex</i>                 |                 |
| <i>Benjamin B. Downing</i>     | <i>Berkshire, Hampshire, Franklin and Hampden</i> |                 |
| <i>Mark C. Montigny</i>        | <i>Second Bristol and Plymouth</i>                | <i>3/9/2015</i> |

*James T. Welch*

*Hampden*

*3/9/2015*

**SENATE . . . . . No. 957**

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By Mr. Brownsberger, a petition (accompanied by bill, Senate, No. 957) of William N. Brownsberger, Lori A. Ehrlich, Jason M. Lewis, Kenneth J. Donnelly and other members of the General Court for legislation relative to the judicial enforcement of noncompetition agreements. Labor and Workforce Development.

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**The Commonwealth of Massachusetts**

**In the One Hundred and Eighty-Ninth General Court  
(2015-2016)**

An Act relative to the judicial enforcement of noncompetition agreements.

*Be it enacted by the Senate and House of Representatives in General Court assembled, and by the authority of the same, as follows:*

1           Chapter 149 of the General Laws of Massachusetts shall be amended by inserting the  
2 following as Section 19D:-

3           Section 19D. Noncompetition Agreements

4           Any written or oral agreement arising out of an employment or independent contractor  
5 relationship that prohibits, impairs, restrains, restricts, or places any condition on a person's  
6 ability to seek, engage in, or accept any type of employment or independent contractor work, for  
7 any period of time after an employment or independent contractor relationship has ended, shall,  
8 to that extent, be void and unenforceable. This section does not render void or unenforceable the  
9 remainder of the agreement containing the unenforceable noncompetition agreement, nor does it  
10 affect (i) covenants not to solicit or hire employees or independent contractors of the employer;  
11 (ii) covenants not to solicit or transact business with actual or prospective customers, clients, or

12 vendors of the employer; (iii) nondisclosure agreements; (iv) noncompetition agreements made  
13 in connection with the sale of a business or partnership or substantially all of the assets of a  
14 business or partnership, when the party restricted by the noncompetition agreement is an owner  
15 of, or partner with, at least a ten percent interest of the business who received significant  
16 consideration for the sale; (v) noncompetition agreements outside of an employment or  
17 independent contractor relationship; (vi) forfeiture agreements; or (vii) agreements by which an  
18 employee agrees to not reapply for employment to the same employer after termination of the  
19 employee.

20       This section shall apply to all contracts and agreements executed after the effective date  
21 of this act.

**HOUSE . . . . . No. 1701****The Commonwealth of Massachusetts**

PRESENTED BY:

***Lori A. Ehrlich****To the Honorable Senate and House of Representatives of the Commonwealth of Massachusetts in General Court assembled:*

The undersigned legislators and/or citizens respectfully petition for the adoption of the accompanying bill:

**An Act relative to the judicial enforcement of noncompetition agreements.**

PETITION OF:

| NAME:                          | DISTRICT/ADDRESS:                   |
|--------------------------------|-------------------------------------|
| <i>Lori A. Ehrlich</i>         | <i>8th Essex</i>                    |
| <i>William N. Brownsberger</i> | <i>Second Suffolk and Middlesex</i> |
| <i>David M. Rogers</i>         | <i>24th Middlesex</i>               |
| <i>Jay D. Livingstone</i>      | <i>8th Suffolk</i>                  |
| <i>Jennifer E. Benson</i>      | <i>37th Middlesex</i>               |
| <i>Kenneth I. Gordon</i>       | <i>21st Middlesex</i>               |
| <i>Tricia Farley-Bouvier</i>   | <i>3rd Berkshire</i>                |
| <i>Jason M. Lewis</i>          | <i>Fifth Middlesex</i>              |
| <i>James R. Miceli</i>         | <i>19th Middlesex</i>               |
| <i>Colleen M. Garry</i>        | <i>36th Middlesex</i>               |
| <i>Dennis A. Rosa</i>          | <i>4th Worcester</i>                |
| <i>Cory Atkins</i>             | <i>14th Middlesex</i>               |
| <i>Marjorie C. Decker</i>      | <i>25th Middlesex</i>               |
| <i>Ruth B. Balser</i>          | <i>12th Middlesex</i>               |
| <i>James M. Cantwell</i>       | <i>4th Plymouth</i>                 |
| <i>Alice Hanlon Peisch</i>     | <i>14th Norfolk</i>                 |
| <i>Tom Sannicandro</i>         | <i>7th Middlesex</i>                |
| <i>Daniel A. Wolf</i>          | <i>Cape and Islands</i>             |

|                            |                                |
|----------------------------|--------------------------------|
| <i>Patricia D. Jehlen</i>  | <i>Second Middlesex</i>        |
| <i>Kay Khan</i>            | <i>11th Middlesex</i>          |
| <i>Edward F. Coppinger</i> | <i>10th Suffolk</i>            |
| <i>Louis L. Kafka</i>      | <i>8th Norfolk</i>             |
| <i>Carlos Gonzalez</i>     | <i>10th Hampden</i>            |
| <i>James B. Eldridge</i>   | <i>Middlesex and Worcester</i> |
| <i>Chris Walsh</i>         | <i>6th Middlesex</i>           |
| <i>Diana DiZoglio</i>      | <i>14th Essex</i>              |
| <i>Elizabeth A. Malia</i>  | <i>11th Suffolk</i>            |
| <i>Sean Garballey</i>      | <i>23rd Middlesex</i>          |



# HOUSE . . . . . No. 1701

By Ms. Ehrlich of Marblehead, a petition (accompanied by bill, House, No. 1701) of Lori A. Ehrlich and others for legislation to limit the time that former employees must wait before being employed by a competitor. Labor and Workforce Development.

[SIMILAR MATTER FILED IN PREVIOUS SESSION  
SEE HOUSE, NO. 1715 OF 2013-2014.]

## The Commonwealth of Massachusetts

In the One Hundred and Eighty-Ninth General Court  
(2015-2016)

An Act relative to the judicial enforcement of noncompetition agreements.

*Be it enacted by the Senate and House of Representatives in General Court assembled, and by the authority of the same, as follows:*

1 Chapter 149 of the General Laws of Massachusetts shall be amended by inserting the  
2 following as Section 19D:

3 Section 19D. Noncompetition Agreements

4 Any written or oral agreement arising out of an employment or independent contractor  
5 relationship that prohibits, impairs, restrains, restricts, or places any condition on a person's  
6 ability to seek, engage in, or accept any type of employment or independent contractor work, for  
7 any period of time after an employment or independent contractor relationship has ended, shall,  
8 to that extent, be void and unenforceable. This section does not render void or unenforceable the  
9 remainder of the agreement containing the unenforceable noncompetition agreement, nor does it

10 preclude the imposition by a court, through a temporary restraining order, preliminary injunction,  
11 permanent injunction, or otherwise, of a noncompetition restriction as a provisional or permanent  
12 remedy for a breach of another contractual obligation or violation of a statutory or common law  
13 duty. Nor shall this section affect (i) covenants not to solicit or hire employees or independent  
14 contractors of the employer; (ii) covenants not to solicit or transact business with customers,  
15 clients, or vendors of the employer; (iii) nondisclosure agreements; (iv) noncompetition  
16 agreements made in connection with the sale of a business or partnership or substantially all of  
17 the assets of a business, when the party restricted by the noncompetition agreement is an owner  
18 of, or partner with, at least a ten percent interest of the business who received significant  
19 consideration for the sale; (v) noncompetition agreements outside of an employment or  
20 independent contractor relationship; (vi) forfeiture agreements; or (vii) agreements by which an  
21 employee agrees to not reapply for employment to the same employer after termination of the  
22 employee.

23       This section shall apply to all contracts and agreements executed after the effective date  
24 of this act.

## **CHAPTER 3**

**HISTORY:**  
**The Massachusetts Legislature's Efforts  
Concerning Non-Competes and other Forms  
of Post-Employment Restrictive Covenants**

There has been a flurry of activity on Beacon Hill in recent years concerning the law of post-employment restrictive covenants in Massachusetts. Many Massachusetts companies are familiar with the use of non-competes, particularly when it comes to the employment of sales personnel. And Massachusetts law has for well over a century favored the enforcement of well-crafted non-competition agreements. Since 2009, however, there has been some willingness within the Massachusetts Legislature to completely revamp the existing non-compete legal landscape. Several proposed bills have sought to bring sweeping changes in the law of non-competes, as well as other post-employment restrictive covenants. These efforts within the Legislature have in essence attempted to move Massachusetts more in the direction of California when it comes to the enforceability of non-competition agreements. Although stopping short of California's complete ban of non-competes, the Massachusetts legislative proposals would certainly result in the creation of barriers to enforcement which many businesses may not be able to overcome.

For example, on January 5, 2009, House Bill No. 1794, "An Act To Prohibit Restrictive Employment Covenants," was introduced in the Massachusetts House of Representatives.<sup>1</sup> The Act proposed to amend Section 19 of Chapter 149<sup>2</sup> of the General Laws by adding the following paragraph:

Any written or oral contract or agreement arising out of an employment relationship that prohibits, impairs, restrains, restricts, or places any condition on,

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<sup>1</sup> House Docket No. 385

<sup>2</sup> Section 19 of Chapter 149 provides: "No person shall, by intimidation or force, prevent or seek to prevent a person from entering into or continuing in the employment of another person."

a person's ability to seek, engage in or accept any type of employment or independent contractor work, for any period of time after an employment relationship has ended, shall be void and unenforceable with respect to that restriction. This section shall not render void or unenforceable the remainder of the contract or agreement.

HO 1794. This simple paragraph inserted into the General Laws of the Commonwealth would have effectively brought to an end the enforceability of any type of post-employment restrictive covenant, effectuating a sea change in the present state of the common law. The broad proscriptive language would have outlawed not only non-competition agreements, but also other forms of post-employment restrictive covenants such as non-solicitation agreements and anti-piracy agreements. Under this formulation, one could easily argue that a non-solicitation agreement prohibiting a former employee from contacting the customers he serviced at his prior workplace would be illegal, since it arguably “impairs ... a person’s ability to seek, engage in or accept” employment.

On January 13, 2009, an “Act Relative to Non-Compete Agreements,” House No. 1799<sup>3</sup> was introduced during the same legislative session. This bill deals only with non-competition agreements, and no other form of post-employment restrictions. Nevertheless, HO 1799 established certain bright-line enforceability rules not currently found in the common law of Massachusetts. For instance, Section (c) prohibits the enforcement of a non-competition clause against an employee “whose annual gross salary and commission, calculated on an annual basis at the time of the employee’s termination, is less than \$100,000[.]” Also, HO 1799 prohibited non-competition provisions extending beyond 2 years. The Act also allowed for garden leave provisions, but only if the employer paid the ex-employee the greater of: 50% of the employee’s annual gross base salary and commissions, or \$100,000. Clearly, this was a high price to pay in order to protect one’s intellectual property and customer goodwill.

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<sup>3</sup> House Docket No. 1078

Both Acts would have altered considerably the existing “non-compete” jurisprudence in Massachusetts, particularly for employers who rely on post-employment restrictive covenants to protect customer goodwill, and to minimize the possibility of unfair competition by former employees. Several business interests in Massachusetts, such as the Smaller Business Association of New England (“SBANE”) and Associated Industries of Massachusetts (“AIM”), weighed in on these legislative formulations, characterizing them for the most part as too “employee biased.”<sup>4</sup> Subsequently, a new formulation of “An Act Relative to Non-Compete Agreements” appeared late in 2009 as a “compromise bill.” It called for the following minimum requirements for enforceable non-compete agreements:

- the agreement must be in writing and signed by the employee and the employer;
- must apply only to employees making more than \$75,000 annually;
- can only be of one (1) year’s duration;
- must be provided 7 business days before commencement of employment;
- and
- makes additional consideration in the amount of 10% of the employee’s compensation presumptively reasonable where a non-compete agreement is put before an employee after the commencement of employment.

Such bright-line rules for enforceability do not exist in the present common-law jurisprudence. They are clearly meant to establish baseline legal requirements, and also impose certain employer costs of enforceability which presently do not exist. Perhaps the most controversial aspect of HO 1799 is its attorney’s fees provision. The Act calls for the mandatory award of attorney’s fees to the employee *even in cases where the employer was successful in Court in enforcing the non-compete provision*. This provision is contrary to the long-standing and well-

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<sup>4</sup> The author served as Chairman of SBANE from October 2009 - October 2011.

recognized “American Rule” which requires litigants to bear their own costs and expenses, irrespective of outcome.

In October 2010 the Joint Committee on Labor and Workforce Development held the requisite public hearing on the latest formulation of the HO 1799. The author testified at the hearing along with various other business owners who felt essentially that the bill as formulated would weaken the business climate in Massachusetts by making it more difficult and expensive for businesses to protect customer goodwill and other proprietary matter. The bill was reported favorably out of committee, but was not taken up by the full Legislature. Accordingly, the Act and its various formulations effectively died at the end of the 2010 legislative session.

The 2011-2013 legislative session saw the introduction of yet another round of bill proposals regarding restrictive covenants. On January 20, 2011, “An Act Relative to Noncompetition Agreements,” was reintroduced in the Massachusetts House of Representatives as HO 2293.<sup>5</sup> The mandatory minimum salary requirement was eliminated, as was the 10% payment as presumptively adequate consideration when a non-compete agreement is presented to an employee after commencement of employment. The new version of HO 1799 also recognizes garden leave provisions. The mandatory attorney’s fees provision remains in place as a substantial “wild card” and deterrent concerning enforcement actions. On January 21, 2011, “An Act Relative to the Prohibition of Noncompetition Agreements”<sup>6</sup> was filed with the Massachusetts House as HO 2296. This proposal is very simple in formulation but profound in impact - should it become law. It provides in pertinent part:

Except as provided in this Section, any contract that serves to restrict an employee or former employee from engaging in a lawful profession, trade or business of any kind is deemed unlawful.

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<sup>5</sup> House Docket 02018

<sup>6</sup> House Docket 02713

The language of HO 2296 is similar to that of HO 1794 introduced in 2009. In a way, HO 2296 “was déjà vu all over again,” as it more or less mirrored the restrictions set forth in HO 1794 which began the legislative foray into this area back in January 2009. It would serve effectively to outlaw in Massachusetts most forms of post-employment restrictive covenants.

Both HO 2293 and HO 2296 have been assigned to the Joint Committee on Labor and Workforce Development. Public hearings on these bills are expected to occur in the fall of 2011.

Since their initial appearance in 2009, these bills have been touted as “job creation” mechanisms, the argument being that prohibiting non-competes would allow for greater employee mobility and therefore increased hiring. A 2009 study of the effect of non-compete agreements on the biotech industry, however, reached a very different conclusion:

Our results suggest that the legal structure in California that places no restrictions on post-employment activities hinders firm’s research and development activities. We believe this occurs because firms cannot protect the tacit knowledge held by employees. We also considered the issues of whether legal structure was more important to younger and smaller firms. Our results here suggest that smaller firms are particularly affected by the legal structure in California. The results clearly highlight the importance of legal structure when firms are particularly reliant upon competitive advantages based upon tacit knowledge.

See Non-Competition Agreements And Research Productivity in the Biotechnology Industry, Cooms and Taylor (University of Richmond, 2009). An earlier study from 2000 compared the legal environment of Silicon Valley, California, where non-competes are illegal, to that of other high-tech areas such as Route 128 in Massachusetts, North Carolina’s Research Triangle, and Austin, Texas. This study found no “growth-stifling effects” of non-competes in the geographic areas which enforce them:

There is no doubt that Silicon Valley has experienced unmatched success over the last few years, but when data reflecting the success of the four regions is adjusted to measure the successes of the four regions in relative terms, it seems clear that all four areas are experiencing very high rates of



growth, in terms of the number of new technology-related businesses, the amount of venture capital investment, and the number of venture capital transactions. In short, all four are high technology boomtowns. If there is validity [to the] theory that California's prohibition of noncompetition clauses in employment agreements was a critical factor in the development of Silicon Valley culture and its associated success, then one would expect the four regions' levels of success, as measured by growth in the high technology and emerging companies sector, to correlate in some fashion with the extent to which each region tends to enforce such covenants. Unfortunately, the available data for the last few years does not seem to correlate with each region's law in such a fashion: despite significant legal differences between the regions, they all seem to be experiencing phenomenal growth and success.

See A Comparison of the Enforceability of Covenants Not to Compete and Recent Economic Histories of Four High Technology Regions, Woods, 5 Va. J.L. and Tech. 14 (2000). A look at the unemployment figures for these regions also tends to negate any purported connection between the prohibition of non-compete agreements and job creation. For example, in May 2011 the unemployment rate for Silicon Valley was 9.7%. During the same time period unemployment in Massachusetts was 7.6% and in the Research Triangle, 7.5%. The statistics for 2010 were even more disparate (see Exhibit 5 hereto). The statewide unemployment rate in California as of June 2010 was 12.3% and in Silicon Valley 11.8%, much worse than the national average of 9.7%. In Massachusetts – where non-competes are routinely enforced – the unemployment rate for the same time period was 9.1% statewide. In the Research Triangle (North Carolina) the unemployment rate in 2010 was 8.0% - much better than the national average at that time. North Carolina also enforces non-competes. (Source: U.S. Bureau of Labor Statistics).

## **CHAPTER 4**

## **A REAL-LIFE ILLUSTRATION OF THE NEED FOR NONCOMPETES**

Life Image was a relatively new start-up company which had developed a “dramatic, cost-cutting” shared imaging product for radiologists which could be accessed over the internet via so-called “cloud” technology. Before selling any products it hired a director of business development tasked with establishing far-reaching sales avenues for the company. The individual hired eventually became vice president of business development. He was apparently involved in the many major strategic business development decisions being made by the start-up. The Vice President’s employment with Life Image was subject to written confidentiality and noncompetition covenants. The non-compete language provided that for a period of 12 months following his termination the Vice President would not “engaged directly or indirectly and any business presently engaged in by life Image or in which Life Image engaged during the term of his employment.”

Approximately two years later, after Life Image had gone to market and caught the attention of a major competitor, the V.P. resigned and went to work for that directly competing company. The Superior Court found that the competitor was well aware that “Life Image was developing and marketing a powerful internet tool that was ground breaking,” and that it had “no equivalent product.” In fact, the competing company had reached out to the Vice President prior to his resignation from Life Image. The court found that the competitor had targeted the Vice President specifically for recruitment because of his position with Life Image. Prior to his departure from the start-up, the V.P. apparently copied the contents of his Life Image laptop computer onto a brand-new Macbook and returned the Life Image computer on the final day of his employment. The court found he carried the complete Life Image product with him on his computer when he left his employer. Forensic evidence also showed that a large amount of Life

Image's files were exported from the V.P.'s company laptop onto an external hard drive prior to his departure.

While there was no evidence adduced that the Vice President had actually conveyed to the competitor any of the Life Image confidential information taken, the Court nevertheless enforced the non-compete based upon what it called "an inevitable misappropriation of confidential information." The court reasoned:

[The Vice President] would necessarily hold in his head or in his computer insider marketing information, i.e., marketing strategy, management, and concepts specific to the cloud-based product. He would have gained this at Life Image....

...

This judge cannot conceive of any way that [the V.P.] could educate his contacts about [the competitor's] emerging products without relying on internal marketing and product data about Life Images competing products.

Thus the court reasoned that the covenant not to compete was enforceable as Life Image maintained a legitimate business interest in protecting its confidential internal marketing and product information. The court also rejected the Vice President's offer to remove himself in his new job from any responsibilities or products that were cloud-based or competing directly with the Life Image product. A promise of non-disclosure, however, was not enough protection for Life Image. The court chastised the Vice President for having deleted files from his personal laptop – "apparently in a panic" - upon receipt of an earlier preservation of evidence order of the same court:

This court is not inclined to permit [the V.P.] to work for [the competitor] in that fashion under a court order not to disclose. His lack of judgment in deleting files upon receipt of the preservation order in the TRO and his solicited advice to [the competitor] about the [Life Image product capabilities] while he was still in the employ of Life Image causes this court to doubt that he is possessed of the ability to wall off in his mind secret strategic marketing information about Life Image while he sells for [the competitor]. *Under these circumstances a court order not to disclose fails to protect Life Image's legitimate business interests.* (Emphasis added.)

In making these rulings in favor of Life Image, the court quoted from the quintessential inevitable disclosure case, finding that "Life Image is 'in the position of a coach, one of whose players has left, *playbook in hand*, to join the opposing team before the big game.'" *Pepsico, Inc. v. Redmond*, 54 F.3d 1262, 1270 (1995). Unfortunately, the behavior of the departing Vice President is not all that atypical. That is why this case is a stark illustration of the importance of maintaining a clear and effective jurisprudence on non-competition law within the state of Massachusetts. This is particularly true since Massachusetts is in many ways a high-tech hub of business activity, and hopefully will remain so.

In light of the favorable jurisprudence illustrated by *Life Image*, passage of the pending legislation would be a most unfortunate development for Massachusetts start-up companies as well as ongoing concerns which rely upon carefully drafted noncompetition agreements to protect the often substantial investments they have made in ground breaking technology.

## **CHAPTER 5**

## **NON-COMPETE FACT SHEET**

*“Facts are stubborn things”*

John Adams

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1) **Rationale** for eliminating non-competition agreements in MA:

“Non-competes hinder start-ups, and thereby hurt the economy.”

**FACT:** Company start-ups in California have declined nearly 50% when one compares the 2009 – 2011 period with 1978 – 1980. During the same comparative time periods, the decline in Massachusetts was 39%. The decline in the San Jose, Sunnyvale, and Santa Clara (“Silicon Valley”) area of CA was nearly 52% in the same period of time. The Austin, Texas area decline was 16%, and the Raleigh/Durham, NC area was about 35%. California does not allow non-competes.

(Source: *Declining Business Dynamism in the United States: A Look at States and Metros* – Robert E. Litan, The Brookings Institute, May 2014).

A recent Kauffman Foundation study put the Cambridge-Newton-Framingham area 4<sup>th</sup> out of 25 metro regions nationally for high-tech start-up density – virtually tied with the San Jose-Sunnyvale-Santa Clara, CA region, *i.e.*, Silicon Valley.

(Source: *Tech Starts: High Technology Business Formation and Job Creation in the United States*, Kauffman Foundation Research Series: Firm Formation and Economic Growth, August 2013)

**2) Rationale for eliminating non-competition agreements in MA:**

“The big companies make employees sign them against their will and then prevent people from getting new jobs. Its David v. Goliath and it’s unfair”

**FACT:** 86% of businesses in MA have 19 or fewer employees. They cannot afford to lose business due to unscrupulous employees. The giant companies are the exception in the state not the norm.

When announcing the recent economic development plan, the Governor himself stated that Massachusetts has 10,000 high tech companies with revenues under \$20 million, and most of those have revenues under \$5 million.

(Source: *Massachusetts Housing and Economic Development Statistic; AP story of April 10, 2014, by Steve LeBlanc.*)

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**3) Rationale for eliminating non-competition agreements in MA:**

“Most employees are honest”

**FACT:** In 2009 The Washington Post reported that “[n]early 60 percent of employees who quit a job or are asked to leave are stealing company data[.]” The article cited a report by the Tucson, AZ based Ponemon Institute. Nearly 80% of those surveyed admitted to taking data even when they knew their employer prohibited such action.

(Source: *Data Theft Common by Departing Employees, by Brian Krebs The Washington Post, February 2009*)

**4) Rationale for eliminating non-competition agreements in MA:**

“The employee can’t really harm the company. It’s crying over spilt milk.”

**FACT:** In smaller companies employees tend to wear many hats of necessity. They are exposed to a lot more proprietary information than they would be in much larger companies. In a recent example of ex-employee mischief, a former salesman left a small high-tech start-up company for a much bigger competitor. The small company had developed a revolutionary new medical imaging technology. Its



former salesman brought the technology to his new employer who was going to offer it free to its customers as an adjunct product.

(Source: *Life Image, Inc. v. Brown*, 29 Mass.L.Rptr. 427, Superior Court 2011)

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**5) Rationale for eliminating non-competition agreements in MA:**

“Non-competes are bad for business and hinder employment growth. It’s common sense.”

**FACT:** In 2010 the statewide unemployment rate in California was 12.3%. In Silicon Valley the unemployment rate was 11.8%. These figures were much worse than the national average of 9.7%. In three areas where non-competes are routinely used and enforced, the unemployment rate at the same time was: 9.1% in Massachusetts; and 8.0% in the Research Triangle of North Carolina.

(Source: *United States Bureau of Labor Statistics*)

A recent study concluded as follows: “our results indicate that California’s unique legal structure is negatively associated with research productivity ... the legal structure in California that places no restrictions on post-employment activities hinders firm’s research and development activities. We believe this occurs because firms cannot protect the tacit knowledge held by employees... Our results here suggest that smaller firms are particularly affected by the legal structure in California.”

(Source: *Non-competition Agreements and Research Productivity in the Biotechnology Industry*, Joseph E. Coombs, Texas A&M University, and Porcher Taylor, University of Richmond.)

Another study from 2000 looked at the effect of non-competes on four high-tech regions: California, Massachusetts, North Carolina/Research Triangle and Texas. The conclusion: The success of the four areas as high tech “boom towns” shows that there is no correlation between enforcing non-competes and the amount of venture capital investment and venture capital transactions.

(Source: *A Comparison of the Enforceability of Covenants Not to Compete and Recent Economic Histories of Four High Technology Regions*, Jason S. Woods, University of Virginia Journal of Law and Technology)

Massachusetts recently ranked first in competitiveness by the Beacon Hill Institute of Suffolk University. The categories examined included human resources, technology, and business incubation, among others.

(Source: *The Boston Business Journal, Annual Analysis Puts Massachusetts in top spot nationally for competitiveness, by Eric Convey, 2014*)

Massachusetts has upheld such restraints in trade at least since 1811.

(Source: *Pierce v. Fuller*, 8 Mass. 223 (1811))

At any given time hundreds - if not thousands - of non-competes expire per their own terms – usually one year.

(Source: *MA Superior Court Case Law/All Counties*)

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**6) Rationale for eliminating non-competition agreements in MA:**

“We’re not getting our fair share of venture capital!”

**FACT:** In 2013 Massachusetts venture capital firms raised more than triple the amount raised in 2012. Massachusetts venture capital firms raised nearly one third of all venture funding in 2013.

(Source: *Venture Capital Firms Booming in Massachusetts, The Boston Globe, January 14, 2014, by Mike Farrell; Thomson Reuters and National Venture Capital Association*)

**7) Rationale for eliminating non-competition agreements in MA:**

“We don’t need non-competes if we have the Uniform Trade Secrets Act.”

**FACT:** The vast majority of the states which enforce non-competes also have the Uniform Trade Secrets Act in place. MA already has a trade secrets statute which allows for multiple damages and attorneys’ fees.

(Source: *G.L. c. 93*)

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**8) Rationale for eliminating non-competition agreements in MA:**

“We don’t need non-competes if we have confidentiality and non-solicitation agreements.”

**FACT:** These agreements are not as good as non-competes when it comes to protecting proprietary information. Many cases enforcing non-competes recognize that an ex-employee either intentionally or inadvertently will utilize proprietary information in their new job with a competitor. And, one cannot “un-ring a bell.” The entire purpose of a non-compete is to protect proprietary information at least until competitors are likely through legitimate means to have become aware of same. Competitors should not be allowed a competitive advantage by avoidance of the costs of invention and discovery.

(Source: *Analogic Case*, 371 Mass. 643 (1976))

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**9) Rationale for eliminating non-competition agreements in MA:**

“Venture capital firms do not like non-compete agreements.”

**FACT:** Non-compete clauses are prevalent among high tech companies in which venture capitalists invest. “For example, Kaplan and Stromberg (2003) find that *venture capital firms required 90 per cent of the founders of the companies they financed to sign non-compete agreements.*”

(Source: *Handbook on Law, Innovation and Growth*, EE Publishing 2011, Edited by Robert E. Liter)

**10) Rationale** for eliminating non-competition agreements in MA:

“Getting rid of non-competes will help the little guy.”

**FACT:** New Hampshire is only a few miles away. The large employers in MA have the means and motive to leave what is already considered an over-regulated business environment. Large-scale job loss ripples through any economy.

(Source: *Fidelity Will Move 1,100 Jobs Out of Mass.*, by Curt Nickisch, WBUR, March 2011)

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**11) Rationale** for eliminating non-competition agreements in MA:

“Adopting the Uniform Trade Secrets Act will add clarity to a confusing area of the law.”

**FACT:** It will take years for the Massachusetts judicial system to interpret the statute’s meaning and proper application. The common law parameters governing the area of enforcement of restrictive covenants are actually quite clear. Equity allows some flexibility, as it should.

(Source: “*The life of the law has not been logic; it has been experience.*” Oliver Wendell Holmes, *The Common Law*, 1881)

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12) **Rationale** for eliminating non-competition agreements in MA:

“Non-competes promote litigation and keep people out of work.”

**FACT:** A typical non-compete enforcement action lasts a matter of weeks - at most - due to the expedited court procedure available to those involved in such a case. And judges in MA have the power to reform the terms of the non-compete contract if they feel it is unfair in some way. Often, this dynamic leads to a settlement that all can live with.

(Source: *EMC Corporation v. Donatelli*, 25 Mass.L.Rptr. 399, Superior Court 2009)

## **CHAPTER 6**

# Why non-compete agreements are needed



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As a practicing attorney for more than 22 years and as chairman of the Smaller Business Association of New England from 2009 to 2011, I've had the opportunity to witness the incredible creativity, initiative and drive of smaller-business owners and operators, who have spurred the Massachusetts economy into one of the most innovative and diverse in the nation, if not the world.

For these nascent enterprises, it often takes many years of trial and error, and significant investment of time, money and energy to get one or two products to the point of marketability. Along the way, a wealth of knowledge and know-how is gained and developed, which becomes the lifeblood of these entrepreneurial endeavors.

The law in Massachusetts has recognized this reality for well over a century, and has allowed companies to protect their intellectual property and confidential business information through the use of restrictive covenants, such as non-compete, non-disclosure and non-solicitation agreements.

Businesses with 19 or fewer employees comprise 86 percent of all companies in the Commonwealth. Because of the relatively small number of personnel and limited financial resources, smaller businesses often require their employees to wear many hats. Consequently, many employees in smaller companies are by necessity exposed to and knowledgeable of a wide variety of company trade secrets and other proprietary information.

Employee non-competition agreements in particular are an integral part of the legal mechanisms used by smaller businesses to protect their intellectual property and other forms of confidential business information. Other forms of restrictive employment covenants such as non-solicitation and non-disclosure agreements, while effective in certain circumstances, do not afford the smaller-business owner



Shutterstock illustration

the same degree of protection.

For example, courts often do not agree as to what constitutes "solicitation" per se. Some cases have found that a "wedding style" new job announcement directed to a former customer does not constitute solicitation of that customer. Customer-initiated contact with a former salesman has also been found to be permissible, despite the existence of a non-solicitation agreement — the focus being on who made the first overture. Non-disclosure agreement violations are often very difficult to detect, and as the saying goes, "you can't un-ring a bell."

Smaller-business owners are often compelled to mortgage their own assets and provide personal guarantees to obtain loans necessary to cover startup costs or fund continuing operations and expansion plans. Why would they continue to do so if unscrupulous employees could simply walk off and exploit for their own economic advantage the end-result of years of development efforts? The cases are legion where just such attempts have been made by ex-employees either working alone or in concert with new competing employers.

Since 2009 there have been varying efforts within the Massachusetts

Legislature to curtail the enforceability of non-competes. Most recently, the governor's office has proposed a complete statewide proscription of non-competes. The rationale advanced for such a ban is that non-competes hinder business startup activity. Proponents of the proposal contend that Massachusetts should strive to be more like California, where non-competes are prohibited.

There simply is no credible evidence, however, that non-competes hinder business startup activity. A May 2014 study by the Brookings Institution demonstrates that startup activity in Massachusetts has surpassed that of California for decades. A 2013 study from the Kauffman Foundation concerning high tech startups found that the Cambridge area was virtually neck and neck with Silicon Valley for startup density, and both areas were in the top five nationally.

The end of the most recent legislative session saw the governor introduce a bill that would have effectively banned non-compete agreements in Massachusetts. The Senate actually passed a prolix version of non-compete "reform" that would have made it more difficult for employers to enforce non-compete agreements. Ultimately, the economic stimulus bill, which passed in both the Senate and the House and went to the governor for signature, did not contain any provision dealing with non-compete agreements.

Under the prevailing common law, non-compete agreements receive strict scrutiny by the courts called upon to enforce them. In fact, the Massachusetts judiciary retains the power under equity principles to reform such agreements when circumstances indicate that certain aspects of the agreement may be impractical or unfair. And the courts do not hesitate to exercise this power. Thus, non-compete agreements must be reasonable in the restrictions they impose and may not be used as punitive devices to simply defeat employee mobility. **NOB**

## **CHAPTER 7**



# **“That’s Not Fair!”**

## **Equitable Principles and Remedies That Can Help Your Business**

### **I. Equity v. The Common Law**

“If the law supposes that...the law is a ass – a idiot.” So stated Mr. Brownlow in Dicken’s *Oliver Twist*, upon learning that in the eyes of the law he was responsible for the actions of his wife. Brownlow went on: “the worst I wish the law is, that his eyes may be opened by experience[.]” Brownlow was expressing the frustration often felt by those facing a purely “legal” and overly simplistic remedy to often complex problems. The great jurist and Supreme Court justice, Oliver Wendell Holmes, Jr., may have harkened to Brownlow’s lament when he wrote nearly fifty years later: “*The life of the law has not been logic: it has been experience....and it cannot be dealt with as if it contained only the axioms and corollaries of a book of mathematics.*” Oliver Wendell Holmes, Jr., *The Common Law* (1881). Enter equity. Equity comes to us from the Roman law. Under the Roman system of justice, certain praetors (or judges) possessed the authority to put aside the rigid rules of the *ius civile* (civil law) “when their strict application would lead to results considered unfair or unresponsive to more advanced social conditions.” Hans Julius Wolff, *Roman Law: An Historical Introduction* (University of Oklahoma Press 1951). The ancient concept of equity eventually made its way into the English legal system, to be administered there by the Chancery Courts. In feudal England, “[t]he King’s Chancellor was given wide powers to prevent injustices or supply deficiencies where the common law was seen to operate unfairly.” Sarah Worthington, *Equity*, 2<sup>nd</sup> Edition (Oxford University Press 2006), 8. Furthermore:

The likelihood that the Common Law and Equity will deliver different responses to the same facts is exacerbated because, from the outset, the Common Law and Equity adopted quite different *remedial strategies*. The Common Law usually gives money remedies....Equity usually reacts differently. It typically orders the defendant to *do* something, perhaps to hand over an item of property, to specifically perform a contract, to cease creating a nuisance, to correct a document...and so forth.

Sarah Worthington, *Equity, 2<sup>nd</sup> Edition* (Oxford University Press 2006), 14 – 15. Fast-forward to America, where our court's adopted the common law/equity applications of the English legal system. Echoing Brownlow's sentiments, a New York jurist once explained: "Law without principle is not law; law without justice is of limited value. Since adherence to principles of 'law' does not invariably produce justice, equity is necessary." *Simonds v. Simonds*, 45 N.Y. 2d 233 (1978). Equitable principles are "unquestionably principles of right, justice and morality[.]" *Id.* The U.S. Supreme Court has stated: "Equity eschews mechanical rules; it depends on flexibility." *Holmberg v. Ambrecht*, 327 U.S. 392, 396 (1946). "In Massachusetts, instead of a distinct and independent Court of Chancery ... we have certain chancery powers conferred upon a court of common law[.]" *Jones v. Newhall*, 115 Mass. 244, 251 (1874). Equity is said to act *in personam*, that is, to command someone to do something or refrain from certain actions, as opposed to simply awarding money damages. Therein lies equity's enormous power and inherent efficacy. For failure to comply with a court's order may lead to severe consequences, such as contempt proceedings, *in terrorem* fines, and in the most extreme instances, a trip to the pokey! While equitable remedies are not perfect, and are at times inconsistently applied – ask ten people what is "fair" in a given situation and you will likely get five different answers – they remain a critical and highly effective means of redressing wrongs, particularly in the business context. What follows are some of the more prevalent and useful equitable concepts currently recognized and available, as well as some real-life examples from my own experiences with equity.

## II. "I Paid for That Property!" - The Resulting Trust

What if you pay for property, but do not hold legal title to same? Can you claim an ownership interest? Yes, as a resulting trust may exist as a matter of equity in your favor:

The doctrine in regard to resulting trusts is settled by numerous decisions... When the money for the purchase of land is paid or furnished by one person, and the deed is taken in the name of another, there is a resulting trust created by implication of law in favor of the former.

*Bailey v. Hemenway*, 147 Mass. 326, 327 – 328 (1888). "Where land conveyed by one person to another is paid for with the money of a third, a trust results to the latter, which is not within the statute of frauds." *McDonough v. O'Neil*, 113 Mass. 92, 95 (1873). In *Davis v. Downer*, 210 Mass. 573, 575 (1912), the SJC found that a resulting trust arose where a partnership, comprised of the plaintiff and his brother, made an initial down payment for a lot which was then conveyed to a third party, the brothers' mother. Four years later the firm paid the mortgages – executed by the mother - for the balance of the purchase price. The Court held:

These facts are sufficient to establish a resulting trust under the well recognized equitable principle, that where one pays for real estate but the conveyance is to another, a resulting trust arises in favor of the one who pays the purchase price against the grantee named in the deed, the later being treated as subject to all the obligations of a trustee, notwithstanding the statute of frauds.

*Id.* The fact that the grantee executed the mortgages was of no moment because it had been agreed *ab initio* that the partnership would pay them, which it did. *Id.* at 575. ("the grantee was thereby exonerated from all liability, and the entire consideration really was paid by the partners.") See also *Caron v. Wades*, 1 Mass. App. Ct. 651, 655 (1974) ("[t]he doctrine of resulting trusts rests on the presumption that 'he who supplies the purchase price intends that the property bought shall inure to his own benefit and not that of another, and that the conveyance is taken in the name of another for some incidental reason'"); *Gerace v. Gerace*, 301 Mass. 14, 18 (1938) (resulting trust arose where plaintiff agreed to pay mortgage note on real estate, although

title was held by another).

## II. “You Took What I Gave” - Account Stated

You should always check your bills, as well as the amounts paid toward same. The concept of account stated precludes a party from complaining that amounts consistently paid and accepted on bills were incorrect, even though the amounts paid and the bills rendered don't jive: The concept of "account stated" had been explicated in several definitions. For example, it has been defined as an agreement between parties who have had previous transactions of a monetary character that all the items of the accounts representing such transactions are true and that the balance struck is correct, together with a promise, express or implied, for the payment of such balance:

It has also been defined as agreement between two parties which constitute a new and binding determination of the balance due on indebtedness arising out of previous transactions of a monetary character, containing a promise, express or implied that the debtor shall pay the full amount of the agreed balance to the creditor. (See *Canadian Ace Brewine Co. v. Swiftsure Beer Co.* (1958), 17 Ill. App. 2d 54, at 60, 149 N.E. 2d 442.) The agreement mentioned in these definitions must, of course, manifest the mutual assent of the debtor and creditor...The meeting of the parties minds upon the correctness of an account is usually the result of one party rendering a statement of account and the other party acquiescing thereto...*The form of the acquiescence or assent is immaterial, however, and the meeting of minds may be inferred from the conduct of the parties and the circumstances of the case.* (See *Pure Torpedo Corp.* 327 Ill. App. at 32-33, 63 N. E. 2d 600.) For example, where a statement of account is rendered by one party to another and is retained by the latter beyond a reasonable time without objection, *the retention of the statement of account without objection within a reasonable time constitutes an acknowledgement and recognition by the latter of the correctness of the account and establishes an account stated.* (citations omitted) (emphasis added).

*Motive Parts Co. of America, Inc. v. Robinson*, 53 Ill.App.3d 935, 369 N.E.2d 119, 122 (Ill. App. 1977). “The assent necessary to make out an account stated ... may be either express or implied.” *Milliken v. Warwick*, 306 Mass. 192, 196 (1940). While often viewed in the context of a plaintiff seeking to establish the existence of a debt, “the doctrine of account stated may be

raised by ...a defendant seeking to prevent the reopening of a paid account...”. *In re Rockefeller Centr Properties*, 272 B.R. 524, (Bankr. SDNY 2000), aff’d 46 Fed App. 40 (2d Cir. 2002). In *Malkov Lumber Company v. Wolf*, 3 Ill. App. 3d 52, 278 N.E. 2d. 481 (1971) a judgment for defendant was reversed where the evidence showed that for more than 5 years plaintiff performed by shipping materials to defendant and invoicing defendant for same. In reversing the trial court based upon an account stated, the Appeals Court held:

That there was a meeting of the minds of the parties as to the correctness of the account balance is shown by the implied acquiescence of Forman upon his receipt of monthly statement of the status of the account and his failure to register an objection thereto.

*Id* at 55. In the circumstances of an account stated, “[t]he action is founded not upon the original contract, but upon the promise to pay the balance ascertained.” *Pure Torpedo Corporation v. Nation*, 327 Ill. App. 28, 34 (1945) citing *Dick v. Zimmerman*, 207 Ill 636, 639. I once used this concept to effectuate a very good settlement. Our client had been delivering goods for a major retailer for nearly ten years, and billing the retailer for his services on a monthly basis. The manager of the warehouse where our client loaded his truck would review the bills, approve them for payment, and then send them to headquarters where a check was cut and sent to the delivery service. Not once during this ten year time period were the amounts set forth on the bills questioned by the retailer. Then, someone at the retailer’s headquarters noticed that the calculations on the bills did not jive with the example calculation set forth in the delivery services contract. Nevertheless, because the retailer had never questioned the amount on the bills or the calculation methodology used to determine same, the retailer – after several days of trial – agreed to accept by way of settlement only a fraction of the reimbursement it was seeking from the delivery company.

### III. “It’s Too Late to Change Your Mind” – Equitable Estoppel

If you sit on your hands too long, you may be compelled to stay there. “Even if [plaintiff] has not waived a known right, he may be estopped from enforcing it.” *Saverslak v. Davis Cleaver Produce Co.*, 606 F.2d 208, 213 (1979) (“[t]he principles of waiver and estoppel support the notion that a party to a contract may not lull another into false assurance that strict compliance with contractual duty will not be required, and then sue for non-compliance.”) In *Saverslak* the court of appeals estopped or prohibited plaintiff from enforcing trademark rights under the express provision of a written contract.

This seven-year period of silent acquiescence in the face of ample opportunity to protest alone evinces Saverslak’s intent to relinquish a known right. The acceptance of royalties makes that intent crystal clear[.]

Alternatively, we hold that regardless of whether Saverslak waived his paragraph 22 rights, he is estopped from enforcing them. We may reasonably assume that Saverslak’s silent acquiescence and acceptance of royalties led Davis-Cleaver to believe that paragraph 22 would no longer be enforced and that it could safely continue to omit the trademark. Had Saverslak instead raised a timely objection the matter might have been resolved with minimum expense and effort. Under these circumstances, we can not allow him to cash in on the false assumption he created and on which the defendant relied to its detriment.

*Id.*

Equitable estoppels arises through a party’s voluntary conduct whereby he is precluded from asserting his rights against another who in good faith relied on such conduct and was therefore led to change his position to his detriment (*Phillips vs. Elrod* (1985), 135 Ill. 3d. 70, 88 Ill. App. Dec. 47, 478 N.E. 2d 1078, 1082.) Unlike waiver, estoppel focuses not on the obligor’s intent, but rather on the effects of his conduct on the obligee. (*Saverslak v. Davis-Cleaver Produce Company* (7th Cir. 1979), 606 F. 2d 208,213, *cert. denied* (1980), 444 U.S. 1078, 100 S. Ct. 1029, 62 Ed, 2d 762.)

*Wald v. Chicago Shippers Association*, 175 Ill. App 3d 607, 622 (1988). “The overarching purpose of the doctrine is to prevent results contrary to ‘good conscience and fair dealing, and its

application is governed by ‘no rigid criteria.’” *Micro Networks Corp. v. HIG Hightec, Inc.*, 195 F.Supp.2d 255, 266 (D. Mass. 2001). In *Micro Networks*, a preferred corporate shareholder of an high tech company was estopped from asserting that it had consent rights over the corporation’s sale of its stock. The shareholder claimed that it never saw a revised Securities Purchase Agreement attachment which did not give it consent rights, even though it had signed the final form SPA without objection. The court found: “If Hightec possessed the extensive veto rights it claims, its representative on Micro Network’s Board of Directors had a duty to be forthright with the Board so that it could inform prospective purchasers of preferred stock of Hightec’s unassailable position with respect to major corporate transactions.” *Id.* at 267.

#### IV. “That’s My Stuff!” – Equitable Replevin

In a dispute concerning business assets or personal property, you are not limited in obtaining only the monetary value of that property – you may be able to get the thing itself back. Under G.L. c. 214, § 3, the Superior court has “equitable jurisdiction to order redelivery of goods or chattels taken or detained from the owner, without requiring the owner first to establish inadequacy of the legal remedy.” Bishop, Vol. 17A, *Mass. Practice Series (Prima Facie Case – Equitable Replevin)* (West 2009), § 49.5, quoting reporter’s note to Mass. R. Civ. P. 65.2. “The common law authorities establish the proposition that an officer may break into a building, such as that here involved, for the purpose of seizing a chattel upon a writ of replevin.” *Broomfield v. Checkoway*, 310 Mass. 68, 69 (1941). The seller of a business came to me seeking to repossess its physical assets as the buyers failed to pay the full purchase price. The agreement called for periodic payments toward the price of the equipment and the goodwill of the company. The buyers made a few of the required payments, and then stopped paying altogether, while holding onto the equipment. We were able to obtain an order from the Superior Court directing the buyers to turn over to the seller all the physical assets of the business, which they did promptly.

In another case, the president of a company reported that he recently discovered that his CFO had stolen over \$1 million dollars. His suspicions were aroused when he and other employees noticed that the CFO had started driving to work in very expensive antique “muscle cars” from the late sixties and early seventies. These vehicles often sold for nearly six figures or more, depending upon the particular vehicle make and model. We discovered that several of these expensive vehicles were being kept by the defendant in a certain locked storage facility. We were able to obtain an order from the Superior Court directing the appropriate Sheriff – waiting across the street from the storage facility with several deputies, bolt cutters, and car carriers - to seize the subject vehicles.

**V. “That’s Not What I Meant!” – Reformation of Contract**

As the saying goes, “nothing is written in stone.” This is particularly true in certain circumstances involving written contracts. “As a general rule, reformation of an instrument may be warranted not only by fraud or by mutual mistake, but also by a mistake of one party ...which is known to the other party[.]” *Torrao v. Cox*, 26 Mass. App. Ct. 247, 250 (1988). “It has been said more generally that ‘[i]f one of the parties mistakenly believes that the writing is a correct integration of that to which he had expressed his assent and the other party knows that it is not, reformation may be decreed.’” *Id.* at 251 (citing *Corbin*, Contracts s. 614 at 730 (1960); *Mates v. Penn Mut. Life Ins. Co.*, 316 Mass. 303, 306 (1944) (“[a] mistake made by one party to the knowledge of the other is equivalent to a mutual mistake.”) Our courts have tremendous equitable powers in this respect. I recently had a non-compete enforcement case where the contract at issue called for a 2 year non-compete period, and an all-New England geographical scope. After hearing the evidence in the form of affidavits, the court enforced the non-compete against a former sales employee, but limited the period to one year, and cut the geographic scope



back to one state only. The court felt that these new parameters were enough to protect the goodwill of the business seeking full enforcement of the contract's terms.

**VI. "It's Pay-back Time" – Money Had and Received**

"An action for money had and received lies to recover money which should not in justice be retained by the defendant, and which in equity and good conscience should be paid to the plaintiff." *Cannon v. Cannon*, 69 Mass. App. Ct. 414, 423 (2007). "The right to recover does not depend upon privity of contract, but on the obligation to restore that which the law implies should be returned, where one is unjustly enriched at another's expense." *Rabinowitz v. People's Nat. Bank*, 235 Mass. 102 (1920). A client reported that he had been enticed by a private fund manager's promises of high yields in very short time spans. The client - an investment manager himself - turned over millions of dollars of his client's money to the private fund manager. The money was supposed to reside in one investment vehicle, but was not placed as promised. When the client learned this and asked for the money back, the investment manager refused to return it! Using the principal above, as well as those of unjust enrichment and restitution, I was able to convince the federal court in Boston to order the freezing of the account at a bank in California where the money was traced. The court further ordered that the funds be returned to the client within a specified period.

**VII. "But You Said You Would Do It" – Specific Performance**

Obtaining a court order directing someone to follow through on the express terms of a contract may be far more valuable - and practical - than seeking money damages for a breach. "It may be taken to be settled in this commonwealth that the question whether a contract will be specifically enforced depends upon the question whether the thing contracted for can be purchased by the plaintiff, and whether damages are an adequate compensation for the breach." *Rigs v. Sokol*, 318 Mass. 337, 342 (1945). "It is settled by our decisions and by the great weight

of authority that the right to specific performance ...by way of injunction not lost because the contract contains a provision for the payment of a penalty on liquidated damages in the event of a breach.” Id. at 342-343. In *Rigs*, the court affirmed the order below which required the defendants to execute a lease for the premises and a bill of sale transferring the good will, fixtures and personal property of a business to the plaintiff, under an agreement to buy same, which the seller refused to honor. “There is a growing tendency to give the promisee the actual performance for which he bargained, if he prefers it, instead of a substitute in damages, where damages are not the equivalent of the performance.” *Sanford v. Boston Edison Co.*, 316 Mass. 631, 634 (1944). In *Butterick Pub. Co. v. Fisher*, 203 Mass. 122 (1909) the court affirmed an injunction prohibiting a retailer from selling any make of patterned clothing other than that supplied by the plaintiff, as had been agreed in a contract between the parties. In another case, a major builder of coal processing plants was stymied when one of its vendors failed to produce and deliver on time a series of multi-ton feed tanks. The builder cancelled the contract as a result of the vendor’s failure to perform as agreed. Under the circumstances, the contract allowed that the builder had the right to request that the vendor send the uncompleted feed tanks to a new vendor for timely completion. The vendor refused. We were able to proceed to court and obtain an order for specific performance, *i.e.*, directing the non-performing vendor to deliver up the incomplete feed tanks to a new manufacturer, as called for in the original contract. A typical example of such specific performance may be found in the circumstances of enforcing the express terms of a non-compete agreement. I recently was called upon to put on live testimony – to have a mini-trial of sorts – in order to hold a departing sales employee to the terms of his non-compete. The employee had lied about his next job to hide the fact that he was going to work for a direct competitor of my client. After several days of testimony, the court allowed the employer’s request that the non-compete agreement be enforced.

### **VIII. "Get Me Outa Here!" – Rescission of Contract**

You may be able to "get out while the gettin' is good" if you come to find out the other side cannot perform as agreed. "A court, in the exercise of its equitable discretion, typically rescinds an agreement only upon a showing of fraud, accident, mistake or some type of gross inequitable conduct which renders the contract void *ab initio*." *PLAY, Inc. v. Nike, Inc.*, 1 F.Supp.2d 60, 65 (D. Mass. 1998). "Rescission is an equitable remedy, and, whenever possible, the result should be to return the parties to the status quo ante." *Ann & Hope, Inc. v. Muratone*, 42 Mass. App. Ct. 223, 230 (1997). "[P]laintiff seeking rescission of a contract must generally 'restore or offer to restore all that he received under [the contract].'" *Id.* In *Ann & Hope*, the court affirmed the rescission of a contract between the retailer and a company which was to provide extended warranty services to customers purchasing goods from the retailer. Under the contract at issue, Ann & Hope was to purchase preprinted warranty cards from defendant and resell them to consumers who purchased major appliances. If repairs to those appliance became necessary, the warranty company was supposed to pay the repair shops directly. It failed to do so. In fact, many of the repair shops billed Ann & Hope directly, and the warranty company refused to reimburse the retailer after it paid these repair bills. The warranty company also charged Ann & Hope for many more warranty cards than it actually wound up delivering. In this case, "the judge determined that rescission was the appropriate remedy due to the difficulty of calculating monetary damages and the practical impossibility of evaluating the parties' continued performance under the contract." In so doing the plaintiff was called upon to restore to the defendant all it had received under the contract, while the plaintiff was entitled to "get back" all it had lost – a value of well over \$2 million dollars.

**IX. "What's Yours is Mine" – Constructive Trust**

"A constructive trust may be said to be a device employed in equity, in the absence of any intention of the parties to create a trust, in order to avoid the unjust enrichment of one party at the expense of the other where legal title to the property was obtained by fraud or in violation of a fiduciary relationship or arose where information confidentially given or acquired was used to the advantage of the recipient at the expense of the one who disclosed the information." *Barry v. Covich*, 332 Mass. 338, 342 (1955). "[O]ur present tendency is to extend its availability not only where there has been a breach of a relationship long recognized as fiduciary but also where there has been the wrongful use of information confidentially given to one for a particular purpose and where instead it has been employed for an entirely different purpose to the gain of the one receiving the information and the detriment of the other." *Id.* at 343. "When property has been acquired in such circumstances that the holder of the legal title may not in good conscience retain the beneficial interest, equity converts him into a trustee." *Simonds v. Simonds*, 45 N.Y. 2d 233 (1978). I was able to use this equitable principle to recover money which was transferred wrongfully out of a corporate account to a personal bank account. A former employee and family member of a small family owned and operated business falsely held himself out as presently employed by the company and was able to convince bank personnel that he had authority to transfer money out of the corporate account. He did, in fact, transfer out tens of thousands of dollars to his own personal bank account from the company's account. I was able to obtain an order essentially freezing the money taken, and then ordering the money replaced into the original corporate account.

**X. "Give That Back!" – Unjust Enrichment/Restitution/Quantum Meruit**

"Restitution is an equitable remedy by which a person who has been unjustly enriched at the expense of another is required to repay the injured party." *Keller v. O'Brien*, 425 Mass. 774,

778 (1997). “A determination of unjust enrichment is one in which ‘[c]onsiderations of equity and morality play a large part.’” *Metropolitan Life Ins. Co. v. Cotter*, 464 Mass. 623, 644 (2013). In fact, unjust enrichment “is defined as ‘retention of money or property of another against the fundamental principles of justice or equity and good conscience.’” *Santagate v. Tower*, 64 Mass. App. Ct. 324, 329 (2005). “Restitution is appropriate ‘only if the circumstances of its receipt or retention are such that, as between the two persons, it is unjust for [one] to retain it.’” *Id.* at 643. Claims for restitution have been allowed “in circumstances involving fraud, bad faith, violation of trust,” or in business torts such as “unfair competition and claims for infringement of trademark or copyright...and ...in disputes arising from quasicontractual relations.” *Id.* at 644. “A quasi contract or a contract implied in law is an obligation created by the law ‘for reasons of justice, without any expression of assent and sometimes even against a clear expression of dissent[.]’” *Salamon v. Terra*, 394 Mass. 857, 859 (1985). A quasi contract ‘is not really a contract, but a legal obligation closely akin to a duty to make restitution.’” *Id.* *Quantum meruit* allows one to recover the fair and reasonable value of services rendered even in the absence of an enforceable express contract. “Quantum meruit is thus a theory of recovery based on an underlying premise of one party’s unjust enrichment.” *Waste Stream Environmental, Inc. v. Lynn Water and Sewer Commission*, 15 Mass. L. Rptr. 723 (2003).

I had a case where a major gasoline processor/retailer reported complaints from customers who had attempted to use its gas credit card at a certain location. The would-be customers were told by those managing this specific gas station that only cash was accepted. Upon investigation via drive-by inspection, the retailer learned that a sign with its well-known name was being used to identify the station as one of its retail location when it was not. Somehow, the sign had remained on site even though the location had not been a true location of the gasoline processor/retailer for many years. We proceeded to court on theories of unfair

competition and restitution, since the gas station was falsely claiming to sell our client's well-known brand of gasoline, when in fact it was selling unbranded gas at the location. We obtained an order from the court which not only instructed the station to remove the signs, but also to pay substantial restitution for having improperly traded on our client's well-known name and goodwill.

#### **XI. "Can You Explain That?" – Declaratory Judgment**

A party to a private contract may maintain a suit in equity for a judicial declaration as to the rights of the parties under the agreement. *Zaltman v. Daris*, 331 Mass. 458 (1954). This equitable power has been codified under state statute. See G.L. c. 231A. "In proceedings under the declaratory judgment act, it is the duty of the judge to adjudicate the decisive issues involved in order that the controversy between the parties should be finally settled." *Id.* at 462. A federal analogue exists, the purpose of which has been explained:

The purpose of the Act is to enable a person who is reasonably at legal risk because of an unresolved dispute, to obtain judicial resolution of that dispute without having to await the commencement of legal action by the other side. It accommodates the practical situation wherein the interest of one side to the dispute may be served by delay in taking legal action. However, the controversy must be actual, not hypothetical or of uncertain prospective occurrence.

*BP Chemicals Ltd v. Union Carbide Corp.*, 4 F.3d 975, 977 (Fed. Cir. 1993); 28 U.S.C. §2201.

Declaratory judgment actions are used to resolve disputes over patent rights, whether insurance companies have a duty to defend under a given policy, and to settle disagreements over the meaning and extent of terms contained in private contracts. For example, parties may hotly dispute the meaning and effect of certain terms and conditions to an agreement, and the consequent performance of a party thereunder. If so, either party may ask the court to interpret the contract terms, and fashion a remedy consistent with said interpretation.

## **XII. “What’s Mine is Mine” – Equitable Receivership**

“Jurisdiction to appoint a receiver of a corporation upon the petition of a simple contract creditor cannot be doubted in this Commonwealth.” *New England Theatres v. Olympia Theatres*, 287 Mass. 485, 492 (1934). “A receivership is an equitable remedy designed to protect and preserve the assets of a corporate debtor for those creditors who the court ultimately decides are entitled to them.” *Charlette v. Charlette Bros. Foundry, Inc.*, 59 Mass. App. Ct. 34, 45 (2003) “[R]eceivership is not meant to *determine* or *confer* liability on the corporation or order payment of debts. Rather, receivership is a prophylactic measure to protect assets, *in the event that* a particular creditor can prove that the corporation is liable on a debt.” *Charlette v. Charlette Bros. Foundry, Inc.*, 59 Mass. App. Ct. 34, 46 (2003) (emphasis in original). Such a receivership is not, however, only for the benefit of the petitioning creditor. I had a case where I represented a fairly large creditor of a company that suddenly stopped paying its bills. We learned that the debtor was selectively paying an assortment of other creditors, but not our client. We had received many assurances in writing acknowledging the debt, and promising to pay it – but little money. Concerned that we were “last in line” for payment, we petitioned the court to have a receiver appointed immediately, and the court agreed. The receiver was empowered to take possession of all the debtors books and records, and essentially determine what assets were available to pay which creditors. In essence, the receiver took control of the company, and ultimately “wound down” the business with the court’s imprimatur.

## **XIII. “The Best Offense is a Good Defense” – Equitable Defenses**

### **1. Laches**

Justice delayed may be justice denied. “There is no hard and fast rule as to what constitutes laches. If there has been an unreasonable delay in asserting claims or if, knowing his

rights, a party does not seasonably avail himself of means at hand for their enforcement, but suffers his adversary to incur expense or enter into obligations or otherwise change his position, or in any way be inaction lulls suspicion of his demands to the harm of the other, or if there has been actual or passive acquiescence in the performance of the act complained of, then equity will ordinarily refuse her aid for the establishment of an admitted right, especially if an injunction is asked.” *Stewart v. Finkelstone*, 206 Mass. 28, 36 (1910). “Laches has been defined as ‘the neglect for an unreasonable and unexplained length of time ...to do what in law should have been done[.]’” *Weiner v. Board of Registration of Psychologists*, 416 Mass. 675, 678 (1993). “Mere lapse of time although an important is not necessarily a decisive consideration.” *Stewart*, 206 Mass. at 36. What constitutes unreasonable delay in taking the appropriate action really depends on the circumstances of each case. However, “one cannot fiddle while Rome burns.” If a party is well aware of a harmful or potentially damaging situation, one must act promptly. For example, if you are going to ask a court to enforce a non-compete agreement where you have learned of a violation of same, you can’t wait for months to do so. If you do, the court may refuse to enforce a valid agreement simply because you initially stood by and did nothing.

## **2. Unclean Hands**

“ ‘She who comes into equity must come with clean hands’ ...[T]hus ‘the doors of equity’ are closed ‘to one tainted with inequitableness or bad faith relative to the matter in which [s]he seeks relief, however improper may have been the behavior of the’ other party.” *Fidelity Management & Research Co. v. Ostrander*, 40 Mass. App. Ct. 195, 200 (1996). “[W]hile ‘equity does not demand that its suitors shall have lead blameless lives’ ...as to other matters, it does require that they shall have acted fairly and without fraud or deceit as to the controversy in issue.” *Id.* Thus, it’s important to keep in mind that improper conduct on behalf of one seeking an equitable remedy may very well disqualify that person or entity from receiving the requested



relief.

#### **XIV. “If at First You Don’t Succeed...” – The Single Justice Appeal**

“*Lasciate ogne speranza, voi ch’entrate.*” Dante, *The Divine Comedy* (translation: “Abandon all hope, you who enter.”) Such may be the sentiments of many who are compelled to seek redress through the legal system. When it comes to seeking injunctive relief, however, Massachusetts is rather unique in permitting two bites at the proverbial apple. As mentioned earlier, because equity operates in a somewhat *gestalt*-like environment, it can be hard to predict outcomes at the trial court level. We are fortunate, however, to have a rather quick, efficient mechanism for obtaining “a second opinion” if the first falls short of expectations. Basically, under G.L. c. 231, §118 “[a] party aggrieved by an interlocutory order of a trial court justice in the superior court ... granting...refusing or dissolving a preliminary injunction” may appeal to the Single Justice of the Appeals Court. I recently had a case where we sought injunctive relief at the trial court level due to violations of an employee’s common law duty of loyalty not to compete with his employer while still employed. While the Superior Court refused the injunctive relief, the Single Justice reversed the decision and remanded for further proceedings consistent with his finding that the employee had, in fact, violated his duty of loyalty.

## CHAPTER 8

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## EMPLOYMENT LAW

### Non-competes must be updated to remain effective

*Job changes require new 'consideration' to support agreements*

By Andrew P. Botti

An employer may not rely on a non-competition or nondisclosure agreement signed at the outset of employment. These agreements may need to be updated and re-signed each time the employee is promoted or their role changes.

Several recent Massachusetts court

cases demonstrate the perils of not updating agreements and show that the circumstances under which an employee signs a non-competition agreement can determine whether it will be honored in a later dispute.

In *Lycos, Inc. v. Lincoln Jackson, et al.*, 18 Mass. L. Rep. 256 (August 2004), Lycos developed proprietary products for various online services and routinely required its employees to sign nondisclosure and non-competition covenants.

In March 2000, an employee signed the Lycos non-competition agreement at the commencement of her employment and her compensation was fixed at \$55,000 per year, with additional bonus eligibility. The employee had access to Lycos' confidential business information, including proprietary plans for new products and marketing strategies.

In July 2001, the employee was promoted, and received an increased annual salary. The employee was responsible for the day-to-day search engine operations at Lycos. In January 2002, she received another pay increase. In neither of these instances was the employee asked to sign a new nondisclosure and non-competition agreement.

In March 2004, Lycos promoted the employee again. Her responsibilities expanded to include work on new product initiatives and marketing plans. Her salary increased substantially.

With this latest promotion, however, the employee was asked to sign an Offer Letter describing her promotion, and specifically referencing the nondisclo-

sure and non-competition agreement she signed when her employment with Lycos began. The employee did not sign the letter.

Instead, four months later she resigned and went to work for a direct competitor. Lycos sought an injunction against the employee to enforce the nondisclosure and non-compete covenants. The court denied enforcement, finding that "Lycos cannot demonstrate that the agreement was supported by consideration."

The court pointed out that over the four plus years that the employee was employed by Lycos, the employment relationship varied with respect to her job title, increased responsibilities, salary, bonus, and reporting requirements.

The court stated: "Each time an employee's employment relationship with the employer changes materially such that they have entered into a new employment relationship a new restrictive covenant must be signed."

The decision emphasized that the Offer Letter itself demonstrated that Lycos understood that a material change had occurred in the employer-employee relationship, necessitating a new employment contract containing the desired restrictive covenants.

The Lycos court also explained that "[a]ny time a restrictive covenant is signed by an employee, the employer must provide some clear additional benefit" to the employee.

This is particularly important where the employer asks an employee to sign restrictive covenants after starting a job.



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The point is illustrated clearly in *Engineering Management Support, Inc. v. Puca, et al.*, 19 Mass. L. Rep. 352 (April 2005). In *Puca*, the employer presented the employee with restrictive covenants a week after she began work. No one explained to the employee that she would be required to sign both non-compete and nondisclosure covenants as a condition of employment.

Under the circumstances, the court refused to enforce these covenants against the employee.

"Keeping one's job is insufficient consideration in this case for either the non-competition or confidentiality covenant," the judge wrote. The judge also found that presenting *Puca* with "the Hobson's choice of signing the restrictive covenants or losing her job" may be considered coercive.

*Cypress Group, Inc. v. Stride & Associated, Inc.*, 17 Mass. L. Rep. 436 (February 2004), is another decision meriting attention by in-house counsel. In *Cypress*, three former employees of *Stride*, an I.T. placement company, sought a declaration that the non-competition and non-solicitation agreements they signed were unenforceable.

*Stride* required its employees to sign restrictive covenants prohibiting the solicitation of *Stride's* customers, or working for a *Stride* competitor, for 12 months following termination.

One employee worked for *Stride* for approximately seven years and left to

start her own competing placement firm. To avoid litigation over the non-competition agreement, the employee and *Stride* agreed that the competing entity would refrain from soliciting a specified list of *Stride* clients for a period of six months.

A second employee began as a sales trainee in *Stride's* New York office. When promoted four months later he signed the *Stride* non-compete. In 2000, he signed another non-compete agreement when promoted to practice manager. In October 2001, *Caracciolo* was again promoted by *Stride*, but this time he was not required to sign a new non-compete agreement. Fifteen months later, he was fired for poor performance and soon thereafter began working for *Stride's* direct competitor.

The third employee began work with *Stride* as a low-level sales trainee. He signed the *Stride* non-competition agreement when promoted approximately two years later.

Between January 2000 and March 2003, he was promoted and/or changed positions three more times with *Stride*. None of these position changes required that he sign a new non-competition agreement.

In July 2003, he left *Stride* to work at the competitor. The court refused to enforce the restrictive covenants against either employee number two or number three, citing a lack of consideration.

Both *Lycos* and *Cypress* rely on the leading Massachusetts case of *F.A. Bartlett Tree Expert Company v. Barrington*, 353 Mass. 585 (1968). In *Bartlett Tree*, a salesman left to start his own tree care and landscaping business. His former employer sued, alleging breach of a two-year written non-competition agreement. The court refused to enforce the non-competition agreement, although finding it reasonable in both geographic scope and duration.

The Supreme Judicial Court reasoned that the salesman's terms of employment changed considerably during his 18 years at *Bartlett Tree*. In particular, compensation, sales territory and responsibilities were substantially different when he left the company in 1966, than when he began employment in 1948.

"Such far reaching changes strongly suggest that the parties had abandoned their old arrangement and had entered into a new relationship," the court wrote. *Bartlett Tree*, 363 Mass. at 587.

Employers seeking to protect confidential and proprietary information or to impose non-competes, must provide new agreements supported by additional consideration when the employee's role changes within the company. Otherwise, enforcement may prove futile and the old restrictive covenants not worth the paper they are printed on.

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FINANCIAL SERVICES LAW

## Who owns customer goodwill, after all?

By Andrew Botti

**C**ustomer goodwill, the lifeblood and soul of any business, has long been defined in Massachusetts as "all that goes with a business in excess of its mere capital and physical value, such as reputation for promptness, fidelity, integrity, politeness, business sagacity and commercial skill in the conduct of its affairs, solicitude for the welfare of customers and other intangible elements which contribute to successful commercial adventure." *Martin v. Jablonski*, 253 Mass. 451, 457 (1925).

Goodwill is a well-recognized property right. But in the context of enforcing non-competition

agreements and other restrictive employment covenants, Bay State courts have struggled with the question: "whose goodwill is it, anyway?"

Does customer goodwill belong to sales or account executives - often the only "face" of the corporation known to the consuming public? Or does it belong to the corporation, which provides and produces the desired services, products and know-how, albeit often "behind the scenes?"

Or is goodwill some unique proprietary hybrid, the product of symbiotic relationships not easily divisible like tangible business assets?

Massachusetts trial courts have struggled with the question of goodwill ownership while seeking to strike a balance between the various competing interests involved. The results have not always proven consistent.

Carefully drafted non-competition and non-solicitation agreements can go a long way toward minimizing conflicts over the provenance and ownership of customer goodwill. As the Massachusetts Superior Court cases discussed below illustrate, however, until the appellate courts issue some "bright line" rules, the outcome of the continued imbroglio over customer goodwill promises to remain somewhat unpredictable.

### Balancing act

In *American Express Financial Advisors, Inc. v. Walker*, 9 Mass L. Rep. 242, 1998 Mass Super. Lexis 577, American Express sought to enforce certain restrictive covenants prohibiting its financial advisors for a one-year period after termination from "directly or indirectly offer[ing] for sale, sell[ing] or seek[ing] an application for any Product or Service issued or provided by any company to or from a Client you contacted, dealt with or learned about while you represented [American Express]."

Several financial advisors left American

Express to start their own financial advisory business. They planned to offer the financial and investment products of a broker-dealer entirely unrelated to American Express.

On their way out the door, the departing financial advisors sent thinly veiled solicitations to their current American Express clients, informing them of their new venture. A number of American Express clients subsequently transferred their accounts worth millions of dollars to the new broker-dealer so they could continue receiving financial planning advice from the departing American Express advisors.

American Express sued the departing employees to bar them from accepting any business from their former clients for a period of one year.

The Massachusetts Superior Court recognized that American Express had a legitimate business interest in the clients that had switched over to the new venture, i.e., protection of its own goodwill.

It did so even while noting the financial advisors themselves were encouraged by American Express to be one-on-one "personal" advisors and planners, who cultivated and maintained these sensitive financial relationships.

Nevertheless, the court found that American Express had developed its own goodwill with these clients by: 1) offering a wide range of finan-



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cial products to them albeit through the conduit of the financial advisors; 2) providing important investment information and analysis "gathered and conducted by its 'back-room' employees"; and 3) appropriately supervising and training the financial advisors.

The court recognized that "[f]inancial advisors will look good to their clients only if the clients' portfolios prosper, and those portfolios will not prosper unless the information and analysis furnished to the financial advisors by American Express is sound and the investment vehicles offered by American Express perform as promised."

Conversely, no matter how good American Express' "back room" may be, it will have no "loyal clients unless those clients are satisfied with the advice, attention and 'bedside manner' of their financial advisor."

The court also recognized that the financial advisors had particularly close and sensitive relationships with these clients that warranted a large degree of deference despite the restrictive covenants. Moreover, because of the close nature of the advisor/client relationship, the court was loath to issue an order that in effect prevented the client from using the financial advisor of its choice.

The court noted that "[w]hile the relationship may not be as intimate as that of a doctor and patient or attorney and client, it is plainly a valuable and important personal and financial relationship whose significance, the common law should not categorically ignore."

Ultimately, in balancing the competing interests of American Express, the personal financial advisors, and the clients themselves, the court enjoined the advisors for four months from contacting their former clients - a period long enough "to allow American Express to demonstrate to its clients that the goodwill generated by the departing financial advisor was attributable more to American Express than to the particular skills of that individual."

#### Face time with clients

Not all customer goodwill is recognized as belonging to the employer simply because it may have been developed during the employee's tenure. In *William Gallagher Associates Insurance Broker, Inc. v. Everts*, 13 Mass. L. Rep. 716, 2000 Mass. Super. Lexis 705, the Massachusetts Superior Court, when asked to enforce certain non-compete and non-solicitation covenants against a former salesman, seemed to discount substantially the company support and "back room" aspects of company goodwill expressly recognized in *American Express*.

Everts was a long-time salesman for the William Gallagher company, an insurance broker. During his tenure, Everts serviced more than two dozen accounts. When he left William Gallagher to work

for a competing company, 13 of these customers followed him.

Of these, Everts himself had procured the business of ten anew while employed with William Gallagher. Two other customers Everts had brought with him to William Gallagher from a previous employer. The remaining customer had been a William Gallagher house account.

William Gallagher promptly sued Everts and his new employer over the loss of these 13 customers, and the company goodwill ostensibly associated with them.

William Gallagher argued the goodwill associated with these customers belonged to it, not Everts, for numerous reasons. As Evert's employer, William Gallagher had provided the clerical staff, supplies and customer service representatives needed to service these customers' accounts. The company had also sponsored Evert's attendance at certain sales training programs, and Everts had been accompanied on various sales calls by the company's CEO, as well as a young assistant.

## Massachusetts courts have struggled with the question of goodwill ownership while seeking to strike a balance among the various interests involved. The results have not always proven consistent.

The Superior Court, however, rejected all of these arguments, saying: "While hiring an employee and providing him with an infrastructure necessary for him to do his job undoubtedly gives an employer significant rights to control the employee's conduct, this does not mean that the good will which develops belongs to the employer. There is no evidence . . . this type of support served to enhance plaintiff's reputation with its customers in such a way as to generate good will."

The court found that when Everts left he did not disparage his ex-employer, or otherwise tell these customers that his new employer was superior in the products or services it offered.

That these customers followed Everts upon his mere announcement of resignation did "not show that plaintiff's support created any loyalty to plaintiff. To the contrary, it tends to indicate trust in Everts," according to the court.

As to the ten customers Everts had solicited and developed himself while employed by William Gallagher, the court said the goodwill was of "Everts' own making, which he had developed with customers as a result of his own enthusiasm, personality and abilities." The court pointed out that "[t]he objective of a reasonable

noncompetition clause is to protect the employer's good will, not to appropriate the good will of the employee."

#### Confidential customer information

More recently, the Superior Court in *RIS Paper Company, Inc. v. Wave Graphics, Inc.*, 2006 Mass. Super. Lexis 446, grappled with both the provenance and ownership of customer goodwill in a dispute over misappropriation of allegedly proprietary customer information.

In 1989, a man named DeStefano incorporated a small commercial printer eventually called Wave Graphics, Inc. When the company went bust in late 2003, its name, goodwill and customer lists were auctioned off to Unigraphics, Inc., another commercial printer for which DeStefano and several former Wave Graphics' salesmen had gone to work.

Two of Wave Graphics' creditors mounted a legal challenge to the sale of its customer information to Unigraphics, claiming the information was confidential and proprietary to Wave Graphics, and shouldn't be used by DeStefano and the other for-

mer Wave Graphics salesmen to generate sales for a competing entity.

But the Superior Court disagreed.

Analyzing the practice in the commercial printing business, the court noted it was "customary for salesmen in the industry to change employment and to go with another competitor, taking their customers with them."

In fact, a departing salesman would typically take up to 80 percent of his customers to his new employer. The court concluded that, at least in the commercial printing industry, "What is valuable is not the identity of a customer as such, but rather a salesman's personal relationship with such a customer." These personal relationships "were not a proprietary asset of Wave Graphics" but had been properly acquired by Unigraphics through the hiring of DeStefano and the other former Wave Graphics salesmen, none of whom had signed any form of restrictive employment covenants with Wave Graphics.

There was no misappropriation of trade secrets, proprietary information or goodwill by DeStefano and his new employer, the court ruled.

The court's reasoning seems to echo that of *Richmond Brothers, Inc. v. Westinghouse Broadcasting Company*, 357 Mass. 106, 111 (1970) where the Supreme Judicial Court, citing *Club Aluminum Co. v. Young*, 262 Mass. at 226-227, wrote: "[A]n employer cannot by contract prevent his employee from using the skill and intelligence acquired or increased and improved through experience or through instruction received in the course of the employment. The employee may achieve superiority in his particular department by every lawful means at hand and then, upon the rightful termination of his contract for service, use that superiority for the benefit of rivals in trade of his former employer."

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EMPLOYMENT LAW

## Reach of retaliation claims expanded

By Andrew P. Botti

The U.S. Supreme Court recently gave a big weapon to employees when it ruled that a Civil War era statute – 42 U.S.C. §1981 – encompasses retaliation claims related to workplace discriminatory animus.

Interestingly, the statute itself does not even contain the words “retaliation” or “employment,” yet the court in *CBOCS West, Inc., v. Humphries*, 553 U.S. \_\_\_\_ (2008), reasoned that based on precedent

§1981 applies to the employer-employee relationship.

This ruling has significant ramifications. For instance, an employee proceeding under §1981 for retaliation in the employment context doesn’t have to first go to the Equal Employment Opportunity Commission, and can proceed directly to federal court, using the liberal discovery rules and broad subpoena power typically available in the judicial forum.

Also, a claimant may be a co-employee – perhaps not even a member of a protected class – who seeks to expose and rectify what appears to be unlawful workplace discriminatory animus.

And §1981 claims are not subject to the same cap on damages that limit the monetary recovery available to Title VII claimants. See e.g. *Pollard v. E.I. du Pont de Nemours & Co.*, 532 U.S. 843, 851 (2001).

Unlike Title VII, §1981 allows for personal liability of corporate officers, directors, and employees where they intentionally infringe rights protected under the statute, regardless of whether the corporation may also be liable. See, e.g., *Al-Khazraji v. Saint Francis College*, 784 F.2d 505, 518 (3d Cir. 1986). Such intentional conduct may also raise insurance coverage issues for these corporate agents.

Employers must ensure that all employees understand the importance and reach of the right of freedom from retaliation that §1981 grants to individuals seeking to vindicate rights under anti-discrimination laws.

In the wake of *Humphries*, failure to train personnel on the scope of potential retaliation liability under §1981 could prove extremely costly.

### A look back

The relevant portion of §1981 analyzed in

*Humphries* states: “All persons within the jurisdiction of the United States shall have the same right in every State and Territory to make and enforce contracts[ ]... as is enjoyed by white citizens.”

The predecessor of this statutory language first appeared in Section 1 of the Civil Rights Act of 1866, 14 stat. 27, enacted by Congress shortly after the Dec. 6, 1865 ratification of the 13th Amendment, which Amendment effectively abolished slavery and involuntary servitude in the United States.

After ratification of the 14th Amendment on July 9, 1868, guaranteeing due process and equal protection of the laws to all citizens, Congress passed the Enforcement Act of 1870, 16 stat. 140, which in essence became §1981.

The overarching purpose of these statutes was to eradicate “state-imposed civil disabilities and discriminatory punishments” that Southern legislatures sought to visit on the recently freed slaves. See *General Building Contractors, Inc. v. Pennsylvania United Engineers and Constructors, Inc.*, 458 U.S. 375, 384-88 (1982).

In 1976, the Supreme Court reaffirmed that §1981 applied to the making of private contracts. See *Runyon v. McCrary*, 427 U.S. 160 (1976). From this recognition, it was not a far leap for lower courts to apply §1981 to the at-will “employment contract.”

### §1981 retaliation recognized

A good example of such an application is *Choudhury v. Polytechnic Institute of New York*, 735 F.2d 38 (2nd Cir. 1984), where the 2nd Circuit addressed for the first time the question of whether an employee’s claim that his employer retaliated against him for filing a complaint for racial discrimination was recognized by §1981.



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Choudhury, an Asian Indian, was a professor in the physics department of the Polytechnic Institute of New York. After five years he was appointed a full professor with tenure. Several years later, Choudhury discovered he was the lowest paid full professor in the Institute's physics department.

He filed a discrimination complaint with the Equal Employment Opportunity Commission. The matter settled when the Institute agreed to a salary increase and additional research monies for Choudhury.

Approximately one year later, Choudhury claimed his treatment by Polytechnic "took a dramatic turn for the worse." *Id.* at 40. The poor treatment he alleged included the cancellation of Choudhury's main course offering, failure to reappoint him to departmental committees, and receipt of the lowest merit salary increases.

Choudhury filed a §1981 claim for retaliation, alleging these adverse job actions were "payback" for having filed the earlier discrimination claim.

Joining the 5th, 6th and 8th Circuits, the 2nd Circuit recognized Choudhury's cause of action for retaliation under Section 1981.

The 2nd Circuit went on to hold that a §1981 retaliation claimant need not show the retaliation itself was motivated by racial animus, or even prove the underlying discrimination complaint to maintain a successful retaliation action.

However, in June 1989 the U.S. Supreme Court ruled that "racial harassment relating to the conditions of employment is not actionable under §1981 because that provision does not apply to conduct which occurs after the formation of a contract, and which does not interfere with the right to enforce established contract obligations."

*Patterson v. McLean Credit Union*, 491 US 164, 171 (1989). (Emphasis added.)

This reasoning effectively eliminated retaliation claims under §1981 since such claims naturally arise during the course of the employment relationship – not at its inception. The court in *Patterson* also noted that extending §1981 claims to "post-employment conduct" would "undermine the detailed and well-crafted procedures for conciliation and resolution of Title VII claims."

Title VII claims of race discrimination are subject to the comprehensive administrative apparatus established by Congress and implemented by the EEOC, while §1981 provides no administrative review or opportunity for conciliation. *Patterson*, 491 U.S. at 181-82.

#### Congress reacts

In 1991, Congress passed the Civil Rights Act of 1991, 105 Stat. 1071, largely to supersede *Patterson's* narrow reading of §1981. The 1991 Civil Rights Act added a provision – §1981(b) – expanding the meaning of "contract" to include performance, modification and termination of the agreement.

The House report stated that the statute is meant "to bar all race discrimination in contractual relations. ... In the context of employment discrimination ... this would include, but not be limited to, claims of harassment, discharge, demotion, promotion, transfer, retaliation, and hiring" (Emphasis added.) H.R. Rep. No. 102-40(I), at 92 (1991), reprinted in 1991 U.S.C.C.A.N. 549, 630.

#### The *Humphries* ruling

For the first time since passage the Civil Rights Act of 1991, the Supreme Court in *Humphries* addressed whether §1981 encom-

passed a claim for retaliation in the employment context.

The plaintiff-employee in *Humphries* complained to his managers about what he believed to be the racially-motivated discharge of a black co-employee. *Humphries* claimed he was, in turn, fired for doing so, and sued for retaliatory discharge under §1981.

In affirming that §1981 encompassed retaliation claims like *Humphries'*, the court relied on *Sullivan v. Little Hunting Park, Inc.*, 396 U.S. 225 (1969), a case involving §1982 – long recognized as a companion statute to §1981 – which provides that "[a]ll citizens of the United States shall have the same right, in every State and Territory, as is enjoyed by white citizens thereof, to inherit, purchase, lease, sell, hold, and convey real and personal property."

*Sullivan*, a white man, rented his home to a black man. *Sullivan* also assigned to the black renter shares in a corporation that allowed the owner to use an adjacent private park.

The corporation controlling the park refused to allow the assignment because the rentor/assignee was black. When *Sullivan* protested, the association expelled him and took back his membership shares. *Sullivan* sued the association, claiming a violation of §1982, and the Supreme Court upheld *Sullivan's* claim.

Interestingly, both the *Humphries* and *Sullivan* retaliation claimants ultimately were not the individuals asserting claims of racial discrimination on their own behalf. Thus, the Supreme Court's reading of §1981 confers broad-based protection to all employees seeking to vindicate anti-discrimination rights – regardless of whether such employees are the original victims of workplace discrimination.

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## SJC rejects court-imposed 'buy-out' of minority shareholder

By Andrew Botti

The Massachusetts Supreme Judicial Court recently overturned a court-ordered buy-out of a minority shareholder's interest in a closely held business, saying it was not an appropriate remedy for a "freeze-out" by the controlling shareholder group.

The trial court's equitable "buy-out" remedy had been affirmed by the Massachusetts Appeals Court in May 2006, but the SJC saw things differently.

"The problem with this remedy," according to the SJC, "is that it placed the plaintiff in a significantly better position than she would

have enjoyed absent the wrongdoing, and well exceeded her reasonable expectations of benefit from her shares" *Brodie v. Jordan*, 2006 Mass. Lexis 696.

The SJC left untouched the lower court rulings in favor of liability.

The Appeals Court decision affirming the lower court ruling ordering the buy-out had been the first appellate case in Massachusetts to do so. See *Brodie v. Jordan*, 66 Mass. App. Ct. 371 (2006).

The long and circuitous path of the *Brodie* case is a stark reminder to business owners and their counsel of the necessity of careful advance planning for the inevitable changes in ownership and management that occur in privately held businesses.

The case is a wake-up call for all closely held businesses that currently operate without a clear and comprehensive buy/sell agreement and stock transfer restriction in place. A well-constructed buy/sell agreement should address a variety of contingencies relating to future stock disposition, such as an owner's death, retirement, disability, or simply the desire to walk away.

Even the best business marriages may end in divorce and the promoters of a closely held corporation need to anticipate a time when the honeymoon comes to an end.

### Strained relations

A brief recounting of the facts of the case and the lower court findings and rulings is instructive. In 1973, three individuals - Walter S. Brodie, David J. Barbuto, and Guy J. Agri - organized Malden Centerless Grinding, Inc. to manufacture round metal objects such as ball bearings.

Six years later, Agri resigned and Brodie became president. Brodie and Barbuto remained the only two officers and shareholders of the company until 1984 when Robert J. Jordan became an equal shareholder with Brodie and Barbuto. Jordan soon assumed the daily operations of the company.

Eventually, considerable friction developed between Brodie and Jordan, culminating in

the removal of Brodie as a director. Brodie remained, however, a co-equal shareholder with Barbuto and Jordan.

Walter Brodie died in 1997. Upon Brodie's death, his wife, Mary, became the owner of his shares. She apparently had little or no knowledge of the company's business. Nevertheless, she sought a position as a director of the corporation. Mary Brodie also sought information on Malden's financial condition, requested an audit, and sought a determination of the value of her 400 shares.

The majority shareholders denied her requests. As in the case of her husband, Walter, it appeared the controlling shareholders considered Mary Brodie a "nuisance" and an "aggravation."

Mary Brodie was not, however, without recourse. She sued the other shareholders for breach of fiduciary duty.

While the case was pending, the majority shareholders suggested that if Mary Brodie wanted to offer Malden her shares, she should follow the procedures outlined in the company's articles of organization.

The articles contained a stock transfer restriction with a built-in stock valuation procedure involving the use of arbitrators to determine share price. The articles, however, did not require the company to purchase the shares once valued. They only required that the shares be offered first to the company, which had the option to decline their purchase. Mary Brodie did in fact commence the requisite procedure, but the majority shareholders stymied her efforts to follow through when they realized the expense which such an appraisal process would entail. She found herself holding 400 shares of stock with no ready market for them, she had no meaningful financial information on the company of which she was part owner, and she was essentially barred from participating in the enterprise.

### The lower courts weigh in

Massachusetts law has long held that stock



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holders in a close corporation such as Malden owe one another "substantially the same fiduciary duty in the operation of the enterprise that partners own to one another." *Donahue v. Rodd Electrotype Co. of New England, Inc.* 367 Mass. 578, 593 (1975).

As the Massachusetts Superior Court stated in the trial court ruling in *Brodie*, the "[c]ontrolling shareholders' fiduciary duty to minority shareholders includes the duty not to interfere with the minority's reasonable expectations of the benefits of ownership in the corporation and the duty to disclose information to the minority."

A court called upon to examine the actions of the majority shareholders vis-à-vis the minority must determine if there was a legitimate business purpose for the controlling group's actions, and "weigh the asserted business purpose against the practicality of any less harmful alternative."

The Superior Court, examining Mary Brodie's predicament, concluded there was "[a]mple evidence presented at trial to support a conclusion that [the] defendants engage[d] in a pattern of conduct that constituted a 'freeze-out' of the plaintiff in violation of the defendants' fiduciary duty."

The Appeals Court affirmed this finding, agreeing with the Superior Court's characterization of the majority's behavior as constituting a pattern of "stonewalling." The Appeals Court described the litany of oppressive behavior one might expect from the majority:

"Typical majority actions constituting a freeze-out include denying a minority a corporate office or employment, refusing to declare dividends, treating the value of the minority's shares in an unequal manner, and excluding or isolating a minority shareholder from information, operations, and decision-making." 66 Mass. App. Ct. at 375-76.

In Mary Brodie's case, this pattern manifested itself when the majority denied her a corporate office, limited her to receiving annual, unaudited financials, and refused to pay dividends – the net effect of which was to ensure she would "derive no benefit from her shares."

Particularly egregious, the Appeals Court found, was the majority's refusal to abide the stock transfer restriction in the company's articles of organization – "a provision of corporate governance...not to be taken lightly." It was incumbent upon the company's directors – who were also its majority shareholders – to take the prescribed steps to determine, by arbitration, the value of Brodie's shares.

Although the directors were not obligated to purchase the shares once valued, their failure to follow through with the arbitration process was a breach of their fiduciary duty to Brodie as a minority shareholder.

The Superior Court ruled the appropriate remedy was a buy-out of plaintiff's shares at a price informed by the testimony of a court appointed expert.

In affirming this ruling, the Appeals Court

wrote: "While there rarely is a market value for a small, close corporation's shares that bears any relation to the shares' true value, a freeze-out absolutely destroys whatever value otherwise exists. Where there is a freeze-out, the remedy ordered here restores to the plaintiff what she lost – or an approximation thereof – in the only way possible. Forcing the parties to maintain a relationship none of them wants is not good for them or for the corporation and is bound to breed more litigation." 66 Mass. App. Ct. at 386.

The SJC rejected this rationale for the forced buy-out remedy, concluding it "would require a forced share purchase in virtually every freeze-out case, given that resort to litigation is itself an indication of the inability of shareholders to work together."

Because neither the articles of organization nor the corporation's buy-laws required Malden to purchase Mary Brodie's shares, she had no "reasonable expectation of having her shares bought out."

The SJC also pointed out that minority shareholders in Massachusetts have no statutory right to involuntary dissolution because of majority shareholder misconduct. The SJC did not specify what would be a reasonable remedy under the circumstance, but remanded the case to the Superior Court for an evidentiary hearing on the issue.

The saga of Mary Brodie will doubtless continue.

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