

Non-Competition Agreements in Cyberspace

By STEVEN COOPER AND ELLIE A. LEVY

Ne can hardly imagine cyberspace two years from now. Indeed, the Massachusetts Institute of Technology's business school buried an Internet time capsule in 1999. Its purpose was to show, upon opening, how differently things were done in the past. The opening date is 2004. With change occurring this rapidly in the Internet world, more and more e-businesses are struggling with how to retain their valued employees. In the traditional business environment, a company's one or two-year non-competition or non-solicitation restraint on its employees generally was reasonable. Not, however, in the dot.com world. Employers must consider this rapid evolution when implementing techniques for keeping good employees — as well as in avoiding liability when acquiring skilled employees from competitors. These trends are reflected in an important recent decision of the United States Court of Appeals for the Second Circuit, *EarthWeb v. Schlack*.

Traditional Rules

Restrictive covenants are the commonly-used contractual devices designed to prevent former employees from pursuing certain employment opportunities with competitors. Restrictive covenants in employment agreements include non-competition agreements, non-solicitation agreements, and confidentiality agreements. Courts will only uphold reasonable restraints.

Courts evaluate the reasonableness of the restraints that non-competition agreements impose on employees on a case-by-case basis. Traditionally, courts determine

reasonableness by examining (1) the duration; (2) the territorial coverage; and (3) the scope of activities that a non-competition agreement prohibits. Indeed, if a non-compete clause is part of a larger agreement, most courts will examine the entire agreement to determine if it is fair. In so doing, an attempt is made to strike a balance between an employer's and an employee's interests: an employee's right to earn a living and compete in the marketplace, versus what is necessary to protect an employer's legitimate business interests.

An employer has a legitimate interest in protecting confidential information or trade secrets. Additionally, when an employer invests time and money in training its employees, it has a legitimate interest in having those skills applied to its company, as well as preventing those skills from benefiting its competitors. Employers may also protect against the departure of employees with unique or extraordinary skills.

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Claimants Found to be Customers of Brokerage Firm Under SIPA: The United States Court of Appeals for the Eleventh Circuit found that clients of an insolvent brokerage firm were "customers" under the Securities Investor Protection Act, thus entitling them to funds from the brokerage firm's estate and the Securities Investor Protection Corporation. The Court stated that Congress passed SIPA "to protect investors when their brokerages fail," and rejected arguments that the claimants did not meet the SIPA definition of customers. Specifically, the Court found that claimants — who were unwitting participants in a Ponzi scheme whereby they invested money for short periods of time and were to receive substantial interest payments — had lost money when they deposited funds with the brokerage firm for the purchase of securities. In so doing, the Court rejected the SIPA trustee's arguments that the transactions at issue were "investment fund" transactions, and were out of the ordinary course of the securities firm's business. *In re: Old Naples Securities, Inc.*

Cyberspace Rules

Many of the traditional rules with respect to non-competition agreements simply cannot be applied to the fast-paced and ever-changing world of cyberspace.

Time Restrictions. What is the reasonable period of time to restrict an employee in the Internet industry? The court in *EarthWeb* addressed this issue. Mark Schlack, a former Vice President of EarthWeb, Inc., a company that provides online products and services to business professionals in the information technology industry, signed a one year post-employment non-competition agreement. About a year later, Schlack accepted a position with Itworld.com, a subsidiary of International Data Group, Inc. (IDG). EarthWeb sued, arguing that Schlack should be enjoined from working for IDG because that company would directly compete with EarthWeb.

Schlack clearly had what would be considered to be confidential technical information, which normally would bolster EarthWeb's case that the non-

compete agreement should be enforced. But the nature of this information, namely that it dealt with Internet technology, actually destroyed the former employer's claim. As information technology evolves, an employee's existing knowledge about an Internet company will gradually diminish because that information is quickly outdated. For instance, EarthWeb had plans to revamp its software infrastructure in the near future; any related knowledge that Schlack had was soon to become obsolete. The court found the proposed one-year restriction to be too long. In fact, the court described a one-year restraint as being "several generations, if not an eternity" in the context of Internet-related businesses. It cited with approval a case involving two Internet advertising businesses where the court upheld a six-month non-competition provision. However, the court refused to shorten the time of restraint and instead struck the provision altogether.

Geographical Restrictions. Companies and courts must also grapple with the territorial scope of a restrictive covenant when determining reasonableness. Typically, a non-competition agreement restricts an employee's freedom to work in a specific geographic area. For traditional businesses, this area is fairly easy to determine. The employer looks at the territory in which the employer sells products and provides services, as well as the area in which the employee had contact with customers. But cyberspace has no boundaries, and Internet employers find it difficult to impose geographical boundaries in restrictive covenants. Indeed, the non-compete provisions in *EarthWeb* did not contain a geographical restraint. Nonetheless, this issue arises frequently, and an employer cannot prevent an employee from working everywhere. If there are logical geographical boundaries that should be restricted, i.e. particular websites or e-mail addresses, these should be consid-

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Qualified Immunity Applied to Form U-5 Defamation Suit: A Judge in the Southern District of New York, after sifting through competing legal authority, confirmed an arbitration award for, among other things, defamation. In so doing, the Court ruled that statements made on a Form U-5 are subject to a qualified—rather than an absolute—privilege. The Form U-5, which must be filed by securities industry firms when a registered person leaves their employ, requires a statement of the person's reason for termination, as well as an explanation. The Court confirmed an arbitration panel's finding that the firm's statements that its former employee failed to perform his supervisory duties, and was under internal investigation for fraud, removing personnel files from his office and regulatory violations, were defamatory, as the qualified privilege was overcome by a showing of malice. *Acciardo v. Millenium Securities Corp.*

Second Circuit Holds Plaintiffs to "Strong Inference" of Scienter Standard: Holding that the Private Securities Litigation Reform Act "adopted our 'strong inference' standard" and raised the national pleading level to that which existed in the Second Circuit before the PSLRA, that Court reinstated shareholder securities fraud class action claims against Ann Taylor stores. The Court held that "[i]n order to plead scienter, plaintiffs must state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind" The Court found the pleading at issue sufficient as it alleged fact which, if proven, would show that the defendants "knowingly and intentionally issued financial statements that overstated Ann Taylor's financial condition" *Novak v. Kasaks.*

ered. Absent that, the reasonableness analysis will likely become subject-matter or activity-based, rather than geographically-based.

Activity Restrictions. Non-competition agreements may proscribe the types of services that an employee can perform for a former employer's competitors. This technique can permit an employer to restrict a former employee's activities without concern for geographical boundaries. The scope of a non-competition provision should not exceed the current job description of the employee. If it does, the court is likely to strike it for being too broad, as restrictive covenants are disfavored and, as such, will be strictly construed.

In *EarthWeb*, the court considered all provisions in the employment agreement and stated that their effect was "to indenture the employee to EarthWeb." This determination weighed heavily in Schlack's favor. The non-compete clause laid out three narrow categories of employment in which Schlack agreed not to compete: companies whose "primary business" is providing information technology professionals with (1) a "directory" of third party technology, (2) an "online reference library," or (3) an "online store." The court strictly construed the provision and found that Schlack's prospective employment did not directly fit into one of the prohibited categories. Therefore, Schlack's new position was not covered by the provision and he was free to take the new job.

Tips and Guidelines

The following guidelines should aid in protecting employees and avoiding liability for Internet companies when trying to retain employees.

1. Keep the time period restriction as short as possible. A period of a

few months is often construed as reasonable and will likely be upheld.

2. Attempt to prospectively restrict only those activities which are narrowly tailored to the person's existing job function.
3. Make clear in employment contracts the extent to which the employee is privy to confidential trade secret information, and set forth why the information is secret.
4. When hiring, review the employee's existing agreements with the prior employer in order to avoid potential claims that you are interfering with an existing contractual relationship.

Prudent and intelligent drafting of restrictive covenants in connection with dot.com and other businesses will result in such agreements being upheld by the courts. ■

Steven Cooper is a partner in the New York office of Anderson Kill & Olick, P.C. His practice includes representation of employers and employees in restrictive covenant/trade secret matters. Ellie A. Levy was a Summer Associate in the New York office this past summer.

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Proxy Fraud Must Cause Loss for Securities Fraud Claim: The United States Court of Appeals for the Second Circuit held, in a case of first impression, that minority shareholders who were "frozen out," and subsequently brought suit under Section 10(b) of the Securities Exchange Act of 1934, must show that the allegedly fraudulent proxy statement caused their injury. The Court ruled that, just as with a claim under Section 14(a) of the 1934 Act – the proxy fraud provision – a proxy fraud claim under Section 10(b) requires that both transaction causation and loss causation be shown. Causation could not be shown by the minority shareholders as their votes were not needed in order to approve the merger, and thus they could not have been defrauded by the proxy statements into approving the merger. *Grace v. Rosenstock*.

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Accounting Malpractice and Fraud Complaint Proceeds: AKO won a major victory for its client Jackson National Life Insurance Company ("JNL") in an accounting malpractice and fraud suit against Ernst & Young LLP ("E&Y") in the Supreme Court of the State of New York, County of New York. In its suit, JNL alleged that E&Y's audits of electronics wholesaler Kent International Associates, Ltd. ("Kent"), to whom JNL was a lender, were negligent and fraudulent in that, among other things, E&Y failed to determine that many of Kent's sales and accounts receivable were fictitious. The Court denied E&Y's motion to dismiss the complaint, finding that JNL has sufficiently alleged a relationship approaching privity with E&Y, and that JNL had properly alleged fraud. *Jackson National Life Ins. Co. v. Ernst & Young (consolidated with LaSalle National Bank, et al. v. Ernst & Young, LLP)*.

Summary Judgment Granted Based On Wrongful Cancellation Of Insurance Policies: AKO's client, New York Apple Tours, Inc. ("NY Apple"), which offers bus tours around New York, purchased two commercial insurance policies from TRM International Inc. ("TRM") in 1995. The one-year term policies went into effect April 1, 1995. In December of 1995, however, NY Apple received a cancellation letter from TRM stating its policies were canceled for allegedly "failing to supply pertinent underwriting information." NY Apple was thus forced to purchase immediate replacement insurance to cover its tour business. Ruling from the bench, New York Supreme Court Justice Barbara R. Kapnick granted summary judgment to NY Apple, finding that TRM wrongfully and unlawfully canceled NY Apple's policies in violation of New York Insurance Law Section 3426(c) and the endorsements contained in the policies themselves. "Based on the insurance law and based on this particular policy, that was not grounds, a permissible grounds, for canceling a policy," Judge Kapnick said. *TRM International Inc. v. American Phoenix Corporation of New York Inc. v. New York Apple Tours, Inc., et al.*

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For more information, contact Co-Editors **Jordan W. Siev, Esq., (212) 278-1542, jsiev@andersonkill.com**; **Ann S. Ginsberg, Esq., (212) 278-1512, aginsberg@andersonkill.com**; or **Mark L. Weyman, Chair, Commercial Litigation Department, (212) 278-1852, mweyman@andersonkill.com**. Rich Mansfield, Publisher, PRI (732) 548-4609. Copyright © Anderson Kill & Olick, P.C., 2000. All rights reserved.