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News & Types: Employment, Labor & Benefits Update

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Employment – Sometimes, Less Restriction is More Protection in Restrictive Covenants

By Nancy E. Sasamoto

Executive Summary: After acquiring 2 companies in 2011 as part of a deal valued at $53 million, AssuredPartners ("AP") required employees of the acquired companies to sign employment agreements that included broad confidentiality, noncompetition and nonsolicitation provisions. One of those employees, William Schmitt, signed a 4-year contract with a guaranteed base salary of $240,000, plus bonus opportunity. When Schmitt resigned in 2013, AP unsuccessfully sought to enforce the restrictive covenants, which the trial court found "unreasonable as a matter of law." On October 26, 2015, the Illinois Appellate Court affirmed the trial court holding that the confidentiality, noncompetition and nonsolicitation provisions of Schmitt's agreement were overly broad. Moreover, the Court declined to modify the restrictions and enforce them as modified. *AssuredPartners, Inc. v. William Schmitt*, 2015 IL App (1st) 141863, 2015 Ill. App. LEXIS 813 (Ill. App. Ct. 1st Dist. 2015).

Schmitt was a wholesale insurance broker who began working in the insurance industry in the early 1990's. Since 2003, he primarily handled lawyers' professional liability insurance (LPLI). In 2003 to 2006, while working for a company called ProQuest, "he ‘plac[ed] millions of dollars in LPLI with insurers in the United States and also in the United Kingdom.' In addition, during that time, he established ‘contacts with LPLI retail brokers and insurers, which spanned approximately a dozen of the fifty United States as well as the United Kingdom.'"

In 2006, he joined another company, ProAccess, as a senior vice president. He was required to sign an employment agreement that included confidentiality, nonsolicitation and noncompetition restrictions. However, the agreement expressly carved out "any lawyer's professional liability relationship produced in the ProAccess Mid-West office" in "recognition that [Schmitt's] LPLI customers, contacts, and expertise predated [his] work with ProAccess." ProAccess was one of the company's that AP acquired in 2011.

After AP acquired ProAccess, Schmitt signed a Senior Management Agreement ("SMA"), which required him to comply with certain restrictions on his business activities during his employment and for a period of time after his termination. Unlike the ProQuest agreement, there were no exclusions from the restrictions.

Soon after Schmitt resigned, he began "‘broker[ing] wholesale LPLI under the umbrella of a retail insurance brokerage'" and sending his new contact information to the customers named in a ProAccess customer

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expiration list that he had serviced during his employment. AP filed suit alleging claims for breach of contract, tortious interference with prospective economic advantage, and preliminary and permanent injunctive relief.

In reviewing the enforceability of the noncompetition provision, the Court reiterated the "rule of reasonableness" established by the Illinois Supreme court. A restraint on trade is reasonable only if it: (1) is no greater than is required to protect a legitimate business interest of the employer; (2) does not impose undue hardship on the employee; and (3) is not injurious to the public. Id. Furthermore, the activity, time, and geographic restrictions must be reasonable.

Under this test, the Court held that the noncompetition provision was unreasonable because it prohibited Schmitt from engaging in any "portion of the Restricted Business that relates to professional liability Insurance Products or professional liability Related Services" anywhere in the United States or its territories". Essentially, AP's restrictions acted as a blanket prohibition to bar Schmitt from working as a broker, in any capacity, within the entire universe of professional liability insurance business, which the Court held was unreasonable.

The Court held that the nonsolicitation provision was broader than necessary to protect plaintiffs' interest in preventing Schmitt from exploiting the client relationships he developed and maintained during his employment at ProAccess. "Instead of just protecting those customer and vendor/supplier relationships that Schmitt developed while working for plaintiffs, section 3(b) seeks to prevent Schmitt from gaining business from *any* ‘Potential Target, customer, supplier, licensee or other business relation'—regardless of whether the entity was involved in the LPLI trade—with whom any of the plaintiff entities *and* their subsidiaries have interacted."

Finally, the Court found that the confidentiality provision was unreasonable because it prohibited Schmitt from improperly disclosing or using *any information* he obtained or *any observations* he made while employed at ProAcess, regardless of whether they were actually confidential. Moreover, the Court refused to modify the overly broad provisions to make them reasonable because doing so would be tantamount to drafting a new agreement.

In this age of job mobility, employers frequently use confidentiality agreements and restrictive covenants to protect their trade secrets and protect against former employees walking away with their customers. In this area of the law, "broader" is not necessarily better. Employers should also keep in mind that whether restrictions are unreasonable or overly broad depends on the particular circumstances. Therefore, there is no single model agreement that all employers can use and employers may even need to modify the terms on an employee-by-employee basis.

Labor – Arbitrating Non-Competes in California: A Different Standard?

By Asa W. Markel

California's famous ban on non-competition agreements, at first glance, seems insurmountable. In 2008, the California Supreme Court ostensibly declared California's ban of non-competes absolute when it rejected the "narrow restraint" exception, which had been fashioned by the federal courts to allow employers to enforce non-competes against former employees. However, exceptions exist to California's general stance against enforcement of non-competes. For example, California's non-compete statute specifically permits non-

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competes to be enforced against departing partners or sellers of businesses. *See* Business and Professions Code section 16602. Moreover, a recent California Court of Appeal decision in *SingerLewak LLP v. Gantman*, case no. B259722, 2015 Cal. App. LEXIS 929 (Cal. App. Jul. 29, 2015) highlighted the reach of one of the exceptions to the ban on non-competes.

In *Gantman*, the Court of Appeal found that there was no public policy basis to disregard an arbitrator's decision to enforce a non-compete against a departing partner. In *Gantman*, Gantman, a departing partner, argued at arbitration that a non-compete provision did not apply to him because he did not fall under the definition of "partner" contemplated by Business and Professions Code section 16602. The arbitrator was unconvinced by the partner's argument, stating that the partner did, in fact, fall under the definition of "partner" under section 16602. Further, the arbitrator made an interesting determination: that what was, for all purposes, a non-compete was *not* a non-compete, but, instead, "a provision allowing competition but imposing a cost on departing partners who service clients of the firm." The arbitrator stated that section 16602 was not aimed at such provisions, and, thus, the provision "imposing a cost" on the partner was enforceable. The partner appealed the arbitrator's decision to the California Court of Appeal.

The *Gantman* court noted that evaluating a challenge to an arbitration award required two steps: "first, the court must determine whether the award is reviewable" and, second, "if review is appropriate…the court consider[s] whether the award should be upheld." The threshold question in determining whether the arbitration award in *Gantman* was reviewable was, the court observed, whether "the arbitration award…would be inconsistent with protecting Gantman's statutory rights." In evaluating the reviewability of the award, the *Gantman* court relied on a California Supreme Court case decided earlier this year in which the Supreme Court stated that "arbitrator's may exceed their powers by issuing an award that violates a party's unwaivable statutory rights or that contravenes an explicit expression of public policy." The *Gantman* court, noting that the "public policy in favor of open competition is not absolute" in the context of a partnership or a dissociation of a partner from a partnership, stated that "there is no absolute public policy against the enforcement of a non-competition provision entered into by partners, consistent with section 16602.

In a 2009 case, the Ninth Circuit Court of Appeals had concluded that enforcement by an arbitrator of a non-compete provision subject to California law constituted "manifest disregard of the law," sufficient to overturn the arbitral decision. The *Gantman* decision highlights that arbitrators' enforcement of non-compete provisions against former business owners or partners will not be subject to judicial review under a "manifest disregard" theory.

It is not clear that this kind of deference will extend to cases involving the enforcement of non-competes against departing employees. There is no statutory exception to the non-compete ban for former employees, as opposed to former business owners or partners. Thus, a case of post-employment non-competition restraints against a former employee admittedly deals directly with an "absolute public policy" restriction that *Gantman* conceded would likely warrant judicial review. While California has not specifically recognized a "manifest disregard" basis to overturn arbitral awards, the "absolute public policy" implications of the California's non-compete ban may nevertheless require a similar outcome in the event that employers seek to rely on arbitrators to enforce non-competes against former employees.

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Benefits - Updating 401(k) Plan Beneficiary Elections

By Frank J. Del Barto

When a 401(k) plan participant dies, his or her designated beneficiary is generally entitled to receive the vested interest in the participant's account. Simple, right? However, what happens if the participant fails to update their beneficiary designation due to a life event (marriage or divorce) prior to death? The participant's failure to update his or her beneficiary designation after a life event can often result in the participant's wishes not being followed by the plan administrator, disputes between competing beneficiaries, and the potential for claims for breach of fiduciary duty under ERISA.

Scenario: A current or former plan participant names his children the beneficiary of his or her vested account balance. Years later, the participant marries. Prior to his death, the participant engages in some estate planning and names a trust as the new beneficiary of his 401(k) vested account. The participant dies without having changed the beneficiary designation from his two children to the trust. Expecting to receive the account balance, the trustee files a claim for benefits. Clearly, the deceased participant intended the trust to receive the vested account balance. However, the children are the only beneficiaries on file in the plan's administration system. Should the plan administrator pay the benefits to the trust or to the children?

Response: Neither. In accordance with ERISA, because the spouse of a married participant is deemed to be the designated beneficiary unless the spouse has consented in a writing (witnessed by the plan administrator or a notary) to a different beneficiary, the spouse is entitled to the participant's vested account balance. Here, although the participant intended that the trust be the new beneficiary, because his current spouse did not consent to waive her rights in favor of the trust, she remains entitled to the benefit.

Action: The scenario above is not uncommon. The failure to update beneficiary designations can result in the decedent's intent not being carried out. Because plan administrators, as ERISA fiduciaries, are compelled to follow the terms of the plan and the requirements of ERISA when deciding benefit claims, all employees should be encouraged to review and update all 401(k) plan and group life insurance plan beneficiary designations. Ideally, employers would know when a life event occurs and contact the employee. However, because plan administrators may not know every employee's life events as they occur, we recommend that employers remind employees to confirm their beneficiary designations every year during annual enrollment. Whether the 401(k) account balance or the life insurance benefit is a minimal amount or several hundred thousand dollars, the payment of such benefits to an "unanticipated" beneficiary can lead to heated conversations, unnecessary litigation and legal fees.

For more information about this or any other employment law topic, please contact Frank Del Barto, Chair of the Employment, Labor & Benefits Group, at 847.734.8811 or via email at fdelbarto@masudafunai.com.

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