Good employees are the lifeblood of any successful business. However, to do their jobs properly, and generate profit for the business, employees often need access to sensitive, confidential, or proprietary information of the business that would be devastating in the hands of a competitor. Of course, employees leave businesses – voluntarily or otherwise – all the time. An employee who takes confidential information to a competitor can do catastrophic damage to a business.

One of the most common ways for an employer to protect against this is to limit by contract the companies for which, or places in which, an employee can work after his departure. Such restrictions are called covenants not to compete, or “non-compete” agreements. While the law still favors the free mobility of employees, these agreements can, if properly drafted, be used to effectively safeguard a company’s assets, such as trade secrets, client lists, or other proprietary information. Proper drafting is critical, however, because enforcement may be an “all-or-nothing” proposition. That is, if a court determines that a covenant is overly broad, it may reject the entire covenant, leaving the employer with no protection at all.

Maryland courts are typically reluctant to place limitations on an individual’s choice of employment, and thus generally disfavor covenants not to compete. In order to successfully enforce these agreements, an employer must be able to demonstrate that:

- The employer has an economic interest recognized under law (often called a “protectable interest”); \textit{and}
- The restrictions placed on the employee are no broader than necessary, in duration or geographic scope, to protect that interest.

Essentially, the agreement must strike a fair balance between upholding the public policy of protecting an individual's freedom to work and the need to allow employers to protect their businesses from potential damage caused by departing employees. In practice, this means that balancing these competing interests is a delicate process, depending largely on the nature of each employer’s business, industry, and customer base.

**First Factor: Protectable Interest**

A court faced with a challenge to a covenant not to compete will first determine whether the employer has a “protectable interest.” Employers usu-
ally will have a protectable interest in their relationships with their current customers, even if those customers or relationships were developed by the departing employee. Employers also have protectable interests in trade secrets (such as the formula for a new drug), and other proprietary information (like proprietary pricing mechanisms). Employers generally do not have protectable interests in merely potential customers, or in relationships that the employer has made little or no investment to develop. Customer lists, one of the assets over which non-compete cases are most frequently litigated, are sometimes protected by courts, and sometimes not. There is no bright-line rule for determining which interests a court will protect, but in general, the more unique the asset, and the more the employer has spent to develop it, the more likely a court is to protect it.

SECOND FACTOR: REASONABLE SCOPE AND DURATION

If a court determines that an employer’s interest is protectable, it will then determine whether the duration and geographic scope of the restriction are reasonable. Again, there are no bright-line rules, and the determination is extremely fact-specific. Generally speaking, restrictions lasting a year or less have been found reasonable. In terms of geographic scope, restrictions limited to the area in which the employee has actually conducted the employer’s business, or actually served the employer’s customers, are likely to be reasonable. In addition, a court might uphold a geographic restriction that included an area (like a county or a ZIP code) from which a large number of the employee’s customers (or a large portion of the employer’s revenue) comes, even if the specific employee in question never worked in that particular area. Alternatively, a restrictive covenant may avoid designating a specific geographic area by simply restricting access to the employer’s customers.

ALL-OR-NOTHING ENFORCEMENT

Because Maryland courts disfavor covenants not to compete, agreements containing such covenants must be carefully drafted. Courts will not generally save an over-reaching employer from itself and, if a covenant is overly broad, courts will – with one significant exception – reject the entire covenant. A reviewing court will not add language to a contract, or rewrite the restriction to a scope or duration that it views as reasonable, or otherwise try to save an overly broad covenant. A court can, however, and usually will, strike out words or numbers if doing so would reduce the restriction to a scope that the court considers enforceable. This practice, called “blue-penciling,” is the only exception to all-or-nothing enforcement. So, careful drafters will consider not only the enforceability of a restriction as drafted, but ways in which a reviewing court might “blue-pencil” the restriction if necessary.

REMEDIES

Employers seeking to enforce covenants not to compete have several tools at their disposal. Perhaps the most common is an injunction – an order from the court requiring the employee to do and/or not do something. Usually, this means an order requiring the employee to abide by confidentiality or other agreements, and stop work for his or her new employer. This is often the most effective means of stopping the offending conduct, but also usually the most expensive.

Employers who can prove actual damages (potentially including lost profits) from an employee’s breach of a covenant not to compete can recover those damages from the employee or, in some cases, from the new employer. Seeking only monetary damages will generally be cheaper than seeking an injunction, and may provide some measure of relief, but will not prevent the employee from continuing to work for a competitor.

The simplest remedy, of course, is to remind the employee of his or her obligations in writing, and demand that he or she cease violating his or her restrictive covenant. This approach costs least, but is also least likely to be effective.
Due to the transient nature of today’s employment environment, covenants not to compete, if used properly, can be an effective tool in protecting assets, enhancing client confidence, and deterring competitors from hiring your current employees. Proper drafting is critical, however, because the enforceability of these covenants varies greatly depending on the facts and circumstances of each case, and enforcement is often an all-or-nothing proposition.

**FALL CORPORATE HOUSEKEEPING**

In an unfortunate rite of fall, Maryland law requires the State Comptroller “immediately after September 30 of each year,” to prepare, and send to the State Department of Assessments and Taxation (“SDAT”), a list of every Maryland corporation that has not paid any tax due by October 1 of the year following the year in which the tax was due. The requirement also applies to Maryland Limited Liability Companies (LLCs), and includes a failure to make any required unemployment insurance contributions or reimbursement.

When SDAT receives the list from the Comptroller, it sends each entity on the list a notice that the entity’s charter will be forfeited if the taxes due are not paid by the date stated in the notice. Unfortunately, mailing of the notice is sufficient – *failure to receive the notice does not affect or delay the forfeiture or annulment of corporate existence.*

Most companies, though, find another aspect of the forfeiture law even more troubling, as it is a trap for the unwary business owner. Maryland entities, as well as those formed outside of Maryland but subject to jurisdiction in Maryland (which likely means doing business in Maryland) must file an annual report, and pay the annual report fee. Because the form is called a personal property tax return, many business owners understandably believe that they need not file the form unless the business owns property in Maryland.

Unfortunately, this is not so. The filing requirement (and $300 annual fee) apply to domestic and foreign corporations, limited liability companies (LLCs), limited liability partnerships (LLPs) limited partnerships (LPs), Business Trusts, and Real Estate Investment Trusts (REITs), whether or not they own personal property in Maryland. Immediately after September 30 of each year, the Comptroller certifies to the SDAT a list of entities that have not filed their personal property returns. The SDAT then issues a “proclamation” forfeiting the charters of all non-compliant entities. When a forfeiture occurs, the SDAT will mail notice of forfeiture to the affected entity, at the entity’s address on record with the SDAT.

There are two significant consequences to forfeiture: first, any person who knowingly transacts business in the name of a corporation whose charter has been forfeited and not revived is guilty of a misdemeanor “and on conviction is subject to a fine of not more than $500.” Second, once a corporation’s charter is forfeited, the corporation in its own name can no longer maintain or defend any suit in any Maryland court. Rather, the directors of the corporation become trustees for the assets of the corporation.

Revival of a forfeited charter is a fairly simple matter. First, the forfeited corporation must correct the problem that led to the forfeiture. Once this is done, the corporation should file Articles of Revival. For an LLC, LLP, or LP, file Articles of Reinstatement (form and instructions here).

As a matter of careful housekeeping, the forfeited entity should, after revival, adopt resolutions expressly ratifying all actions taken during the period for which it was without a charter.

If you own or run a business in Maryland, make sure that your business has paid all necessary taxes and has filed a Personal Property Return, even if the business does not own any property. If you are
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unsure, the SDAT maintains a website listing entities subject to forfeiture, and you can check whether your business is in good standing via the SDAT’s Charter Search Page. If your entity has been forfeited, revive it promptly to avoid many headaches later.

COURTS WILL PROTECT A MINORITY SHAREHOLDER’S REASONABLE EXPECTATIONS, BUT USUALLY NOT BY DISSOLVING THE CORPORATION

Case Note: Bontempo v. Lare

Maryland’s intermediate appellate court has recently sounded a cautionary note for all shareholders in small businesses. In Bontempo et al. v. Lare et al., the Maryland Court of Special Appeals confirmed that: (1) a minority shareholder is entitled to have his reasonable expectations protected, (2) majority shareholders, particularly in closely-held corporations, owe their minority counterparts a fiduciary duty not to act inconsistently with those reasonable expectations, (3) the right to continued employment is not automatically a reasonable expectation, and (4) a corporation will be dissolved only if no less drastic remedy is available.

Lare and his wife, co-owners of Quotient Corporation, hired Bontempo and made him a minority shareholder, an officer, and a director. The Lares, Bontempo, and Quotient signed a shareholder’s agreement, which made no mention of employment. They never had any employment agreement, written or oral. After they worked together for several years, Bontempo discovered that the Lares were taking substantial distributions that he was not receiving, and were using company funds to pay personal expenses like salaries and benefits and personal legal fees for their household staff.

The relationship between the three deteriorated, and eventually Lare fired Bontempo because Bontempo refused to resign his position and sell his shares to Lare. Bontempo, who remained an officer, director and shareholder after his firing, sued the Lares and Quotient, seeking (among other things) dissolution of the corporation, an accounting of the monies misappropriated by the Lares, and damages for the termination of his employment. He claimed that the Lares had acted illegally, oppressively, and fraudulently, and thus that the corporation should be dissolved, and he should be awarded the damages described above. Bontempo also asked the court to order Quotient to re-hire him, and/or to award him compensatory and punitive damages for his wrongful termination.

Under Maryland law, a minority shareholder may seek dissolution of a corporation when the controlling shareholder has engaged in illegal, oppressive or fraudulent conduct as to the minority shareholder. Conduct is oppressive if it “substantially defeats expectations that, objectively viewed were both reasonable under the circumstances and were central to the [minority shareholder’s] decision to join the venture.” However, because dissolution is capital punishment for a corporation, and is irrevocable, a court may consider less drastic remedies, and may consider the interests of other stakeholders in the corporation including other shareholders, managers, employees, and customers.

The Lares admitted that they had acted oppressively by diverting company funds to their personal use, but denied that they had acted illegally or fraudulently, denied that the company should be dissolved, and denied that Bontempo was entitled to any compensation for the termination of his employment.

The Court determined that, although the Lares had acted oppressively, they had not acted fraudulently, so punitive damages were not appropriate. Neither the oppressive conduct of the Lares nor their breaches of fiduciary duty rose to the level of fraud, because there was no dishonesty involved. In fact, the Lares avoided punitive damages in part because the diversions of funds to their personal use were accurately recorded on the books of the company.
The Court rejected Bontempo’s employment-related claims because there was no employment agreement outlining his job responsibilities and pay, and because it was clear that Bontempo and the Lares could no longer work together to manage the business.

**WHAT DOES THIS MEAN TO YOU?**

Becoming a minority shareholder is, in the best of circumstances, fraught with substantial risks. Those risks *always* include the risk that the majority will make decisions regarding the business that you disagree with, but that you are powerless to oppose. If you’re going to be working for the company, and want some of the benefits of equity ownership without the risks of becoming a minority shareholder, you might prefer a carefully-crafted incentive compensation plan. Your plan might include things like phantom stock or stock appreciation rights, which function like equity, without actually conferring any ownership.

If you won’t be working for the company, but merely investing in it, you might consider taking pure debt, debt convertible into equity, or a class of preferred equity that gives you certain rights, without embroiling you in the day-to-day minutiae of the company.

If you decide to move forward as a minority shareholder, make absolutely sure that you have a shareholder agreement that expressly sets forth all of your expectations. If you expect to continue to have a job, or a role in managing the company (as an officer, director, or both) or a company car, all of those things should be spelled out in writing. If you are going to work for the company, it is imperative that your specific duties, pay, and conditions of employment are put in a written agreement. When bargaining these terms, you will want to insist that you can be fired only for cause, as specified in the agreement, so that the majority can’t fire you for no reason. Your employment agreement doesn’t have to be separate from your shareholder’s agreement, but it should specifically describe the terms and conditions of your employment.

Majority shareholders, of course, face the same issues from the other side. The tools described above are some (but by no means the only) ways for majority shareholders to provide investors and employees with equity-like incentives and controls, without actually surrendering an ownership interest in the company.

In addition, minority and majority shareholders should both regularly monitor the company’s finances, to the extent authorized to do so. Otherwise, you may find out several years too late that you’ve been paying thousands and thousands of dollars to fund your business partner’s lavish lifestyle. You don’t need to be a balance sheet savant or C.P.A. to spot glaring irregularities such as the ones that prompted Bontempo’s suit. Taking a thorough look at your company’s books, at least quarterly and possibly as often as monthly, should allow you to spot (and address) problems before they mushroom into company-threatening litigation.

**ENFORCING AN ARBITRATION AGREEMENT EVEN IF DOING SO RESULTS IN SEPARATE, SIMULTANEOUS PROCEEDINGS**

*Case Note: Chorley Enterprises, Inc. v. Dickey’s Barbecue Restaurants, Inc.*

Many contracts between commercially-sophisticated parties, and even some between businesses and consumers, contain mandatory arbitration clauses. These are clauses that require the parties to submit their disputes to arbitration instead of going through traditional litigation, which is generally viewed as more costly than arbitration. The relative merits of arbitration versus litigation will be addressed in a future article; recent Maryland law developments,
though, signal a potential trap for the unwary and confirm that – as in most commercial matters -- careful drafting is critical to achieving the desired result.

The U.S. Court of Appeals for the Fourth Circuit recently declared, in Chorley Enterprises, Inc. v. Dickey’s Barbecue Restaurants, Inc., that parties could be forced to try certain parts of their dispute through traditional litigation in court, while submitting others to binding arbitration. The Fourth Circuit’s decision means that many business owners may unwittingly find themselves involved in identical controversies, with the same opponents, in two different forums.

In Chorley, a group of individuals (“Franchisees”), operated franchises owned by Dickey’s Barbeque (“Dickey’s”), the franchisor. The Franchisees, of course, had each signed a franchise agreement with Dickey’s when purchasing their respective franchises. Dickey’s sued the Franchisees, claiming that they had breached their respective franchise agreements by, among other things, failing to maintain and operate their franchises adequately. The Franchisees counter-claimed, asserting (among other things) that Dickey’s had misrepresented to them the costs and expected profits of a franchise.

Dickey’s sought to arbitrate the dispute, under a clause in the franchise agreement requiring arbitration of all claims “arising out of or relating to” the franchise agreement (the “Arbitration Clause”). The Franchisees resisted arbitration, and sued in Federal court in Maryland, relying on another clause in the agreement, which provided that the agreement “shall not require” the franchisees to waive the right to bring any action arising under the Maryland Franchise Law in Maryland courts (the “Maryland Clause”). All of the parties apparently thought that arbitration would be an “all-or-nothing” proposition – that either all of the claims would be arbitrated or none of them would.

The trial court concluded that the two clauses discussed above made the franchise agreement ambiguous, and that a jury should decide which claims, if any, the parties had agreed to arbitrate.

The Fourth Circuit reversed the trial court, holding that Dickey’s claims against the Franchisees must proceed in arbitration, while the Franchisees’ claims against Dickey’s must proceed in Federal court in Maryland. The Fourth Circuit held that – notwithstanding the obvious inefficiency -- the Federal Arbitration Act (the “FAA”) requires piecemeal litigation when an agreement mandates arbitration for some claims but not others.

Finally, the Fourth Circuit concluded that, when read together, the Arbitration Clause and the Maryland Clause demonstrated that the parties agreed to arbitrate all disputes except for the narrow exception outlined in the Maryland Clause (claims arising under the Maryland Franchise Law). The Fourth Circuit was not troubled by the inefficiency of separate proceedings, admonishing that if the parties had intended to avoid the inefficiency, they should have expressly specified so in the franchise agreement.

The Chorley decision means that business owners must be particularly careful with arbitration provisions, both in their own agreements and in agreements drafted by others. Whatever the relative merits of arbitration versus litigation, no proponent of either would seriously argue that doing both simultaneously is preferable to doing either alone.

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