Contracts Tea no. 16 (January-March 2013)

SOUTH CAROLINA

SC Court of Appeals upholds a forfeiture clause and a covenant not to compete of an employment agreement of cardiologists who are shareholders and employees of the company.

The forfeiture of earned but unpaid salary and the non competition duty of two interventional cardiologists who are shareholders and employees of the company are evaluated under a reasonableness standard and found enforceable by the SC Court of Appeals. *Baugh v. Columbia Heart Clinic, P.A.*, Opinion No. 5074 (January 16, 2013).

The cardiologists ("Respondents") were shareholders and employees of Columbia Hear Clinic, P.A. ("Columbia Heart"). Upon becoming shareholders, Respondents signed employment agreements that provided that Respondents would forfeit their salary if they competed with Columbia Heart in either of two specified counties and within one year of termination of their employment. In 2004, they entered into a more robust non-competition provisions[1] (article 4 and 5 of their agreements.)

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[1] Article 4.5(i) read as follows:

> Notwithstanding any other provision in this Agreement in the event at any time during the twelve (12) month period immediately following the expiration or termination (for any reason, whether with or without Cause) of this Agreement Physician continues or commences the active practice of medicine in the field of cardiology within a twenty (20) mile radius of any Columbia Heart office at which Physician routinely provided services during the year prior to the date of expiration or termination of this Agreement, then Physician shall forfeit any monies payable to Physician pursuant to this Section 4.5 following Physician's continuation or commencement of the practice of medicine in violation of this Section 4.5(i).

Article 5.1 contained restrictive language while 5.2 defined the terms used:

> Physician, in the event of termination or expiration of this agreement for any reason, during the twelve (12) month period immediately following the date of termination or expiration of this Agreement, shall not Compete … with Columbia Heart.
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> …
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> "Compete" means directly or indirectly, on his own behalf or on behalf of any other Person, other than at the direction of Columbia Heart and on behalf of Columbia Heart: (A) organizing or owning any interest in a business which engages in the Business in the Territory; (B) engaging in the Business in the Territory; and (C) assisting any Person (as director, officer, employee, agent, consultant, lender, lessor or otherwise) to engage in the Business in the Territory.
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> …
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> "Business" is defined as "the practice of medicine in the field of cardiology."
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> …
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> "Territory" is defined as "the area within a twenty (20) mile radius of any Columbia Heart office at which Physician routinely provided services during the year prior to the date of termination or expiration of this Agreement."

Respondents opened a new cardiology practice on the same campus of the Lexington office of the company and hired away a number of Columbia Heart's employees. Litigation ensued.

The trial court held that the activity restrictions in Article 5 were unreasonable. The trial court also held that the Article 4 restrictions should be struck because they could not be "logically separated from the consequences of violating the non-compete provisions of Article 5."

The Court of Appeals reminded that restrictions on competition are generally disfavored and are only upheld where they are "narrowly drawn to protect the legitimate interests of the employer." The agreement must be (1) supported by consideration;[2] (2) necessary to protect some legitimate interest of the employer; (3) not unduly oppressive in limiting the employee's ability to earn a livelihood; and (4) reasonable from a public policy standpoint.

The Court of Appeals distinguished *J.W. Hunt & Co. v. Davis*[3] on which Columbia Heart relied for the proposition that the Agreements should not be subject to a reasonableness review. According to Columbia Heart, similarly to *Davis*, the Respondents were shareholders in a P.A. that operated as a partnership, not merely employees. The court distinguished *Davis* because here the agreements were contracts for employment. Also, unlike *Davis*, Article 5 of the agreement contained a true covenant not to compete prohibiting specified conduct within a geographic reason for a fixed period of time and Article 4, unlike *Davis*, was a forfeiture clause. There was no precedent declining to apply a reasonableness analysis to a covenant not to compete or a forfeiture clause. For these reasons, the agreements were subject to a reasonableness review.

Even if the court found that the reasonableness analysis was required, it is quite loose in its application. The prohibitions *were reasonable* both in scope of activity and territory: (1) as for the activities, the court held that scope was not overbroad because it did prevent employees from working with or as a competitor in any capacity but only practice of cardiology, directly or indirectly; (2) as for the territory, the court found the

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[2] Respondents argued that no new separate consideration was provided for the Agreements, which should have been provided because the covenant was entered into "after the inception of employment." The court, however, held that separate consideration was provided ($60,000 paid in 12 monthly installments so long as Respondents did not violate Article 5.)

[3] 437 S.E. 2d 557 (1993).

provision was tied to legitimate interests of Columbia Heart[4] and the restriction was not unduly oppressive or harsh because Respondents could practice their specialty outside of the 20 mile radius (there was no evidence that the restriction would prevent them from having a viable practice within the territory after one year.)

As for Respondents' argument that Articles 4 and 5 contained penalties (which unlike liquidated damages, could not be upheld), the court found that damages provided for breach of Article 5 were the reported earnings for the previous calendar year of the average shareholder of Columbia Heart.[5]

The forfeiture for breach of Article 4 included both inability to collect earned but unpaid salary (a defined share of accounts receivable) and the $60,000 severance payment. As a result of this, each Respondent forfeited nearly $240,000 while Columbia Heart's expected revenue loss from a shareholder's departure was just $100,000. However, the court stated that damages resulting from competition are highly difficult to predict and that Columbia Heart's damages could include other sums beyond loss of revenue, such as closure of an office (which had occurred.) In sum, the court found that the $140,000 difference was not an unreasonable estimate.

Employee handbooks containing proper disclaimers do not form a contract but statements made by City employees with some authority may be sufficient to support an estoppel.

Which is the significance of a handbook for employees? Very little, according to a recent opinion of the SC Court of Appeals. However, statements by City employees are a bit more significant because they can justify an estoppel.

In *Bishop v. City of Columbia,*[6] a group of retired firefighters (the "Retirees") claimed they were owed continuing free health insurance under theories of breach of

[4] The plain terms of the Agreements encompassed a 20 mile radius surrounding Columbia Heart offices where Respondents routinely worked and no evidence was put forth that would suggest that a large number of patients came from a distance smaller than the 20 mile radius.

[5] To guide the court's analysis, the court reminded that liquidated damages provisions generally call for a predetermined measure of actual damages that might be sustained in the event of a breach. Where a provision is not a measure of damages but is intended to provide punishment, it will be construed as a penalty.

[6] Opinion No. 5077 (January 23, 2013).

contract, promissory estoppel, and equitable estoppel.[7] After having lost a summary judgment, they appealed.

The Retirees relied on various statements and information provided. First, the Retirees received newsletters stating that insurance was free to them, which was confirmed orally by the City's HR department. Second, supervisors gave assurances that insurance would continue to be free and they accepted lesser salaries. Third, annually during their employment, they received an employee handbook stating that qualifying retired firefighters such as the Retirees would continue under the City's group coverage. However, the cover page of the handbook contained large, bold, capitalized font stating the handbook was "not a contract". The next page of the handbook gave, also in large, capitalized font an "important notice" that "nothing in this handbook . . . shall be deemed to constitute a contract of employment." Fourth, the Retirees received annually an insurance benefits booklet which stated that the health insurance provided was "not just fringe benefits, but because the City pays the vast majority of the cost for [Retirees], they represent a significant cost of compensation far beyond your paycheck."

The court excluded that a contract arose from the employee handbook, the insurance benefits booklet, or the statements by City employees.

As for the employee booklet, the court noted that "an employee handbook forms a contract when: (1) the handbook provisions and procedures in question apply to the employee; (2) the handbook sets out procedures binding on the employer; and (3) the handbook does not contain a conspicuous and appropriate disclaimer." The court opined that the disclaimer language in the handbook were the same as what appeared in *Marr v. City of Columbia*[8] where the South Carolina Supreme Court found that an employee handbook did not create a contract. Also, the Retirees signed numerous forms confirming that the employee handbooks were not contracts. The court held that the disclaimers in this case were effective based on their plain language. Further, South Carolina Code § 41-1-110 was codified in 2004 and states that an employee handbook does not create a contract for employment if it is signed by the employee and contains a conspicuous disclaimer using underlined capital letters on the first page of the document.

As for the insurance benefit booklet, the court excluded that this could create a unilateral contract either: the language of the booklet simply did not contain a promise of continuing free health insurance.

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[7] Prior to July 1, 2009, all current and retired firefighters received no cost group health insurance provided by the city. As a cost-saving measure, the city began requiring contributions from employees and retirees to remain covered under the group health plan after July 1, 2009.

[8] 307 S.C. 545 (1992).

As for the statements made by City employees, the court found that they did not create a unilateral contract, either because those City employees lacked statutory authority to bind the City.[9]

The court found, however, that the Retirees had a viable claim estoppel claim. The Retirees alleged that a promissory and equitable estoppel would lie because of the written materials and the statements by the City employees, on which they relied. While the court held that reliance on the employee handbook and benefits booklet was not reasonable (the employee handbook disclaimed any binding promises and the benefit booklet did not contain any,) the statements of the City employees could be enough to ground an estoppel against the municipality. The court held that the Retirees had produced a "scintilla" of evidence that the statements were made by employees with proper authority for providing insurance benefits advice, and were reasonably relied upon. Therefore summary judgment was improper.

The SC Supreme Court clarifies its position regarding the distinction between the phrases "significant relationship" and "touch matters" as they relate to arbitration clauses.

Is there a difference between "significant relationship" and "touch matters"? In *Landers v. FDIC*,[10] the SC Supreme Court reconciles these two terms, which have been used in the several jurisdictions to determine whether a broad arbitration clause encompasses a claim. The Court stated that some jurisdictions (including the Fourth Circuit) hold that a claim is subject to arbitration if it is "significantly related" to the underlying agreement. Other jurisdictions hold that a claim is arbitrable if it "touches matters" covered by the agreement.

The Court explained that, while the phrases are theoretically interchangeable (the terms were never meant to differ), it appears that over time the "touch matters" phrase and analysis has required a lesser showing to compel arbitration. The Court held that "given the text of the FAA, the United States Supreme Court's interpretation of such, and the strong policy favoring arbitration, … the 'touch matters' term hues more closely to Congressional intent concerning the FAA."

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[9] Based on the city's structure and ordinances, the Retirees needed to provide some evidence that the supervisors or human resources employees statements were authorized in some way by the City Council or City Manager which they failed to do.

[10] Opinion No. 27223

Landers not only reinforces the strong policy favoring arbitration, particularly in cases such as *Landers* where there is a broadly written arbitration clause, but also highlights how a party's complaint can assist a court in enforcing this policy.

Landers served as an executive vice president and then president of Atlantic Bank & Trust ("Bank"). His employment agreement signed contained a broad arbitration clause requiring arbitration for "any controversy or claim arising out of or relating to [the agreement], or breach thereof." The agreement outlined that Landers was to perform his duties at the direction of the CEO. In 2009, Arnold was hired as CEO of Bank and allegedly began a campaign to discredit Landers and ultimately to constructively terminate Landers' employment through abusive statements and disrespectful request. Landers sent a letter to Arnold "recognizing his constructive termination" on December 18, 2009 and claimed that he was later excluded from performing his role as a director. Landers sued asserting five causes of action. Defendants moved to compel arbitration. The trial court granted arbitration only as to the breach of contract claim and defendants appealed arguing arbitration was appropriate for all the claims.

The Court found that Landers' slander and emotional distress tort claims were arbitrable. It does not matter whether the claim required reference to the underlying contract: the FAA's expansive reach does not require that a tort claim be resolved by using some portion of the agreement to be arbitrable. In addition, Landers' complaint alleged that the statements made by Arnold made it impossible for Landers to perform his duties as president, which was the object of the employment agreement. For these reasons, Landers' tort claims, as pleaded, bore a significant relationship to the employment agreement.

As for Landers' illegal proxy solicitation and wrongful expulsion as a director claim, the court found that they were also arbitrable because the "breach thereof" language in the arbitration clause was broad. Since Landers' allegations linked the proxy statement to his improper termination under the employment agreement (the "breach thereof"), then this claim was significantly related to the employment agreement.

As for the wrongful expulsion as a director claim, even if the employment agreement did not address Landers' status as a director, Landers' pleadings provided the necessary nexus for the court to compel arbitration: because Landers claimed that he was frozen out of his position as a result of filing a breach of employment agreement action, then the wrongful expulsion falls under the arbitration provision of the employment agreement.

In the alternative, said the court, it was unclear whether the illegal proxy solicitation and wrongful expulsion claims were outside the scope of the arbitration clause; then, as it is in case of doubts, disputes must be resolved in favor of arbitration.

NEW YORK

Parties that have contracted for New York law to apply under General Obligations Law § 5-1401 do not need to include language that excludes New York's conflict-of-laws principles in order for New York substantive law to apply.

The defendants in *IRB-BrasilResseguros, S.A. v. Inepar Investments, S.A.*[11] were a Brazilian corporation (Inepar S.A. Industria e ConstructionC es ("IIC")), and a corporation from Uruguay (Inepar Investments, S.A. ("Inepar")); the latter owned 60% owner by the first. Inepar issued Global Notes in the Guaranteed Euro Medium-Term Note Program ("Global Note Program") to raise capital and refinance debt of Inepar and IIC. The Global Note Program was governed by a Fiscal Agency Agreement ("Agreement") entered into by Inepar as issuer, IIC as guarantor, and Chase Manhattan bank as the fiscal/paying agent. The Agreement provided that it would be governed by "the laws of the State of New York, without regard to conflict of laws principles."

Plantiff, IRB-Brasil Resseguros, S.A. ("IRB") was a Brazilian corporation that purchased Global Notes from Inepar which Inepar later defaulted on. IIC had guaranteed the Global Notes and the guarantee stated that it would be governed by the law of the State of New York but made no reference to conflict of laws principles. However, the guarantee designated New York as the venue and IIC submitted to the jurisdiction of New York courts.

IRB started an action to recover its investment. IIC moved for summary judgment arguing that the guarantee was void under Brazilian law which was applicable based on New York's choice of laws principles which would result in Brazil's substantive law controlling the issue.

The Court of Appeals of New York relied primarily on General Obligations Law §§ 5-1401(1) and 5-1402(1) and on the legislative history, which shows intent to encourage parties to choose NY law and NY court system.[12] Section 5-1401(1) allows parties to agree that New York law will apply to transactions meeting the $250,000 threshold even if the

[11] 20 N.Y.3d 310 (December 18, 2012).

[12] The legislative history to these statutes, the Court noted, indicates that they were adopted to restrict a court's ability to determine that another jurisdiction has a greater relationship to the transaction under a conflicts analysis in certain situations. The Legislature's fear was that parties would otherwise be deterred from choosing New York's "well-developed system of commercial jurisprudence" due to uncertainty. Taken together, the statutes allow parties to certain transactions to select New York law and avail themselves to New York courts despite lacking New York contacts.

agreement does not bear a reasonable relation to New York. Section 5-1402(1)[13] allows parties to maintain an action in New York where the parties have selected New York law under section 5-1401(1),[14] the transaction meets the $1 million threshold, and where the parties have submitted themselves to the jurisdiction of New York courts.

The Court held that the New York substantive law governed the guarantee because the parties agreed that New York law would control and the transaction exceeded $250,000. IIC argued that the *whole* of New York law should apply, including the conflicts rules, because the guarantee did not expressly exclude New York's conflicts rules. The Court disagreed: "[*e*]*xpress contract language excluding New York's conflict-of-laws principles is not necessary*" because the language of section 5-1401 dictates that New York substantive law controls when an ordinary choice-of-law provision is included in the contract; to hold otherwise would frustrate the legislative purpose. The Court added that the Restatement (Second) of Conflict of Laws is in accord with this approach.

The Court held that a contract should *expressly include* New York's choice-of-law rules if parties wish to have these rules control what substantive law will apply.

Sophisticated parties release their breach of fiduciary duty claims when they sign a release of such claims and they are aware of information that would make reliance on representations of the fiduciary unreasonable.

In *Pappas v. Tzolis*, 20 N.Y.3d 228 (November 27, 2012), Pappas and Ifantopoulos (plaintiffs) and Tzolis (defendant) formed and managed an LLC with the purpose of entering into a long-term lease on a building. An operating agreement for the LLC permitted Tzolis to sublet the property and provided that all three members could engage in any business ventures "whether or not in competition with the LLC, without obligation of any kind to the LLC or to the other Members." In 2006, after the building was subleased by the LLC to a

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[13] Section 5-1402(1):

> any person may maintain an action or proceeding against a foreign corporation, non-resident, or foreign state where the action or proceeding arises out of or relates to any contract, agreement or undertaking for which a choice of New York law has been made in whole or in part pursuant to section 5-1401 and which (a) is a contract, agreement or undertaking, contingent or otherwise, in consideration of, or relating to any obligation arising out of a transaction covering in the aggregate, not less than one million dollars, and (b) which contains a provision or provisions whereby such foreign corporation or non-resident agrees to submit to the jurisdiction of the courts of this state.

[14] Section 5-1401(1):

> The parties to any contract . . . arising out of a transaction covering in the aggregate not less than two hundred fifty thousand dollars . . . may agree that the law of this state shall govern their rights and duties in whole or in part, *whether or not* such contract, agreement or undertaking bears a reasonable relation to this state. (Emphasis added).

company owned by Tzolis, Tzolis took sole possession of the building by paying an additional $20,000 in rent above the amount the LLC paid in rent for the building.[15] In 2007, Tzolis purchased plaintiffs' membership interests in the LLC for an amount 20 times greater than their initial contributions. At closing, plaintiffs signed a certificate that stated they had performed their own due diligence, engaged their own legal counsel, were not relying on any representations of Tzolis, and that Tzolis had no fiduciary duties to plaintiffs in connection with the assignment or their membership interests.

Later that year, the LLC (which was now owned entirely by Tzolis) assigned the lease to a third party for $17.5 million. Plaintiffs later developed the belief that Tzolis had negotiated the deal with the third party prior to purchasing plaintiffs' LLC interests and brought 11 causes of action.

The Supreme Court granted Tzolis' motion to dismiss the complaint in its entirety. The Appellate Division modified the order allowing claims for breach of fiduciary duty, conversion, unjust enrichment, and fraud and misrepresentation to proceed.

The Court of Appeals overturned the Appellate Division with a particularly interesting discussion regarding the breach of fiduciary duty claim.

Plaintiffs contended that Tzolis breached his duty of disclosure by concealing his negotiations while Tzolis argued that the certificate expressly released him from any breach of fiduciary duty claims. The Court cited its holding in *Centro Empresarial Cempresa S.A. v América Móvil S.A.B. de C.V.*[16] where it held that a "sophisticated principal is able to release its fiduciary from claims - at least where . . . the fiduciary relationship is no longer one of unquestioning trust - so long as the principal understands that the fiduciary is acting in its own interest and the release is knowingly entered into." (Citations omitted). In reliance on *Centro*, the Court stated that "[w]here a principal and fiduciary are sophisticated entities and their relationship is not one of trust, the principal cannot reasonably rely on the fiduciary without making additional inquiry." The Court held that the "test, in essence, is whether, given the nature of the parties' relationship at the time of the release, the principal is aware of information about the fiduciary that would make reliance on the fiduciary unreasonable."

The Court noted that here plaintiffs were sophisticated businessmen represented by counsel who, as acknowledged in their own pleadings, had numerous business disputes with Tzolis which made reliance on his representations unreasonable. The Court held that the

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[15] Plaintiffs claimed that they only agreed to this deal because Tzolis had prevented their efforts to sublease the building to a third party, failed to make or assist with improvements that were to be made to the building under the lease, and because Tzolis' company did not pay rent due to the LLC.

[16] 17 N.Y.3d 269 (2011).

certificate precluded any allegations of breach of fiduciary duty by Tzolis. The Court also stated that, as a practical matter, the price for the membership interests which was a substantial increase from the contributions they had made just a year prior should have put plaintiffs on alert.[17]

A liquidated damages clause providing that a down payment is the "sole remedy" in the event of buyer's breach along with contract provisions requiring the down payment to be held in an interest-bearing account leads to seller's waiver of statutory interest.

The Court of Appeals held that statutory interest should not be awarded in a real estate contract dispute. *J. D'Addario & Co., Inc. v. Embassy Industries, Inc.*[18]

Embassy Industries, Inc. ("Embassy") agreed to sell property to J. D'Addario & Co., Inc. ("D'Addario"). The contract called for a down payment of 10% of the purchase price ($650,000) to be held in escrow. The escrow agent had instructions to hold the funds in an interest-bearing account, and would continue to hold the funds in such an account until the resolution of any disputes as to entitlement to the funds. The liquidated damages clause in the contract stated that down payment and any interest accrued thereon would be seller's "sole remedy" and seller would have "no further rights" in the event of buyer's default.

Closing never occurred and a dispute arose as to the down payment. D'Addario commenced an action to recover the down payment and Embassy brought counterclaims. The Supreme Court awarded the down payment along with statutory 9% interest to Embassy. The Appellate Division reversed the interest award.

Embassy argued that the contract did not expressly mention statutory interest and that they never waived their right to it. The Court of Appeals disagreed and held that the combination of the contract language -- which provided for the down payment as the "sole remedy" leaving Embassy with "no further rights" -- and the provision that required the

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[17] Plaintiffs asserted in their fraud and misrepresentation cause of action that Tzolis represented that he was aware of no prospects for selling the lease for a price greater than $2.5 million. The Court dismissed this claim stating that, in essence, plaintiffs' contention was that they were defrauded by representations by Tzolis that they had agreed in the Certificate that they were not relying upon. Regarding conversion of the membership interest, the Court held "since Tzolis had purchased plaintiffs' interests in the LLC, there could be no interference with [plaintiffs'] property rights." As to plaintiffs equitable claim for unjust enrichment, the Court held that such a claim is appropriate only in the absence of an agreement between the parties governing the subject matter. The Court held that this claim failed as a matter of law because there were multiple agreements regarding the sale of the membership interests.

[18] 20 N.Y.3d 113 (November 19, 2012).

down payment to be held in an interest bearing account "was sufficiently clear to establish for purposes of this transaction that interest paid at the statutory rate was not contemplated by the parties at the time the contract was formed." The Court held that the parties decided that the escrowed sum was the exclusive remedy.

The Court noted *in passim* that explicit language in the contract would have prevented the ensuing litigation. We agree: it is a good rule in contract drafting to specify what it is not due under the contract. Including something like "for avoidance of doubt, no statutory interest is due" would have avoided the headache and most of all the legal fees of a litigation.

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