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Breach of Non-Compete Agreements: Establishing Damages

By Steven Aptheker and Russell Penzer

When employers require employees to sign employment agreements it is common for them to include in their employment agreements a covenant not to compete. This restricts an employee's ability to compete with the employer following termination of the employment relationship. If reasonable in duration and scope, such provisions are generally enforced by courts. Employers may seek both injunctive relief against the prohibited competition and monetary damages arising out of any unlawful competition that the former employee has already committed. Proving actual monetary damages in such cases, however, can be very difficult. To avoid having to meet the heavy burden of establishing such actual damages, attorneys representing employers should consider whether inclusion of a liquidated damages provision in their employment agreements is a viable option, especially for high salaried employees or employees that are compensated based on commissions or on performance.

Actual damages

Many employers, and some attorneys, mistakenly believe that they can establish actual damages by showing the earnings that a former employee has realized through its competitive enterprise and seek disgorgement of such earnings. While establishing a former employee's actual earnings would be relatively simple to do through traditional discovery devices, the law in New York is clear that the appropriate measure of actual damages for breach of a non-competition agreement is the profits that the employer can establish that it actually lost, not the extra earnings that the former employee received through his or her wrongful conduct.[1] Thus, to meet its burden of proof, the employer must not just show that the former employee sold products or services to a client or customer that it could have serviced, but also that, had the former employee not done so, the client or customer would have actually purchased such products or services from the employer.

Meeting this burden is not an easy task, and often involves seeking discovery from the subject customers and clients, by subpoena or otherwise. In addition to being costly and time consuming, many employers feel that it is bad business to involve past or potential future customers in their litigation with a former employee. Thus, there are often both legal and business hurdles to proving actual damages in breach of restrictive covenant cases.

Liquidated damages

Given the difficulty in proving actual damages, counsel for employers should consider whether it makes sense, given their client's particular industry and the nature of the employment, to include liquidated damages provisions in their non-competition agreements.

Generally, a liquidated damage provision will be enforced when:

- the damages anticipated as a result of the contractual breach are uncertain in amount or difficult to prove;
- there is an intent by the parties to liquidate such damages in advance;
- and the stipulated sum is "not so grossly disproportionate to the probable anticipated loss as to actually be a penalty designed to induce performance, rather than a means to provide

Steven Aptheker

Russell Penzer

just compensatiofor losses".[2]

In that damages in breach of non-competition cases are often difficult to prove, courts routinely enforce liquidated damage provisions in such agreements where the other requirements for enforcement of such provisions are met.[3] In the usual case, enforcement of a liquidated damage provision in an employment non-compete case turns on whether the amount of the agreed-upon damages is reasonable or constitutes an unenforceable penalty. Significantly, while the employer carries the burden of establishing actual damages in such a case, the party challenging the enforcement of a liquidated damages provision – the former employee – bears the burden of establishing that the provision constitutes an unenforceable penalty.[4] The burden is a heavy one and only where the agreed-upon liquidated damages are "grossly disproportionate to the probable loss" will courts find such a provision to be unenforceable.[5]

While the reasonableness of liquidates damages is a fluid test and depends on the circumstances of each case, such determination is a question of law for the court, and thus, there is a wealth of case-law from which attorneys can draw guideposts in drafting such provisions. As a starting point, employers should be careful not to overreach in fixing a liquidated damages amount. For example, while in one case involving employment by a medical group, liquidated damages of one year's gross salary was deemed to be an unenforceable penalty, in another case, also in the context of employment by a medical group, the court held that liquidated damages of one year's salary capped at $35,000 is reasonable.[6] Attention to such distinctions in drafting liquidated damages provisions will aid an attorney in drafting a provision that is more likely to be enforced by a court of law.

Additionally, courts have expressed a preference for liquidated damages premised upon a formula or calculation, such as one based upon the former employee's past productivity or profitability, rather than a fixed sum or mandatory minimum amount of damages. For example, in *GFI Brokers LLC v. Santana,* the plaintiff, a broker of financial products, sued one of its former employees for *inter alia* breaching a non-competition provision in the parties' employment contract. The employment contract contained a liquidated damages provision whereby damages for such a breach were to be calculated based upon a formula which factored in the former employee's net revenues for the twelve-month period immediately prior to the termination of employment and the number of months left in the agreed-upon term of employment. In enforcing the liquidated damages provision, the court held that "the rough correlation between liquidated damages and actual damages achieved by tying damages to the historical revenue stream – such that the more productive [the former employee] has been, the greater the damages – is a significant virtue over a formula setting a fixed sum or imposing a mandatory minimum amount of damages".[7]

Thus, while the reasonableness of liquidated damages provisions are judged on a case-by-case basis, attorneys can get a great deal of guidance from past decisions analyzing such provisions in drafting employment agreements for their clients. By doing things such as capping liquidated damages based upon gross revenues or providing a formula for the calculation of such damages as opposed to a flat number, it is more likely that the attorney will craft a liquidated damages provision that will be enforced.

While the use of liquidated damages provisions in non-competition agreements is likely to be a good option only in situations involving high salaried employees or employees who are compensated based upon their productivity, such provisions are nonetheless currently an underutilized tool. Attorneys representing employers should counsel their clients with respect to the availability of liquidated damages provisions in such agreements, as well as the potential difficulties in proving actual damages should a former employee breach a non-competition agreement. If armed with this information, an employer wants to include such a liquidated damages provision in its agreements, counsel should draft such a provision with an eye towards past decisional law and the types of liquidated damages provisions that courts have enforced, and those that courts have held to be unenforceable penalties.

Note: Steven Aptheker and Russell Penzer are partners with Lazer, Aptheker, Rosella & Yedid, P.C., which has offices in Melville, New York and West Palm Beach, Florida. Steven Aptheker can be contacted at (631) 761-0820 or at aptheker@larypc.com. Russell Penzer can be contacted at (631) 761-0848 or at penzer@larypc.com.

1. *Earth Alternation, LLC v. Farrell* 21 A.D.3d 873, 874 (2nd Dept. 2005); *Pencom Systems, Inc. v. Shapiro*, 193 A.D.2d 561 (1st Dept. 1993); *Robert Plan Corp. v. Onebeacon Ins.*, 10 Misc.3d 1053(A) (Sup. Ct. Nassau Co. 2005).

2. *Martin L. Ryan, M.D.P.C. v. Orris*, 95 A.D.2d 879, 881 (3rd Dept. 1983) (citations and quotations).

3. *GFI Brokers, LLC v. Santana*, 2009 U.S.Dist.LEXIS 7150 (S.D.N.Y. Aug. 13, 2009); *Martin L. Ryan, M.D.P.C*, 95 A.D.2d at 886.

4. *GFI Brokers, LLC*, 2009 U.S.Dist.LEXIS 7150 at *5.

5. *Id.* (citations and quotations omitted).

6. Compare *Novendstern v. Mt. Kisco Medical Group*, 177 A.D.2d 623 (2nd Dept. 1991) with *Martin L. Ryan, M.D.P.C.*, 95 A.D.2d 879.

7. 2009 U.S.Dist.LEXIS 71550, *9 (S.D.N.Y. Aug. 13, 2009).