

# Compensation Planning Journal

Reproduced with permission from Tax Management Compensation Planning Journal, CPJ, 04/02/2010. Copyright © 2010 by The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>

## Forfeiture-for-Competition Agreements (“Clawbacks”): An Alternative to Traditional Non-Competition Agreements?

by Susan Powell, Esq.  
Finn Dixon & Herling LLP\*

---

### INTRODUCTION

After working for nearly 15 years as a grocery store manager for Food Fair Stores, Inc., Carl Greeley voluntarily resigned from Food Fair to become a retail counselor at a competing grocery store. During his employment with Food Fair, Greeley participated in Food Fair’s noncontributory bonus and retirement plan, which Food Fair funded solely through its profits. The plan provided that Greeley would be eligible for a distribution from his retirement account upon the earlier of his death or attainment of age 65, but further stipulated that Greeley would not be entitled to any distribution if he competed with the company. Notwithstanding the clear terms of the plan, shortly after Greeley resigned from Food Fair to accept a position with its competitor, he filed a claim with Food

Fair for \$8,514.10 allegedly owed to him under the plan. Food Fair promptly informed Greeley that, by choosing to work for a competitor, he had forfeited his benefits under the plan. After all, the plan was clearly a binding contract which relieved Food Fair of its obligation to pay Greeley if Greeley chose to work for a competitor.

Or was it?

Not according to the Court of Appeals of Maryland, where Greeley sued Food Fair for \$8,514.10 — and won.<sup>1</sup> The court held that, although the plan’s forfeiture-for-competition provision did not restrain Greeley’s right to future employment, the non-competition agreement in the plan was nonetheless subject to the standard of “reasonableness” generally applied to traditional non-competition agreements. According to the court, regardless of the mechanism employed (that is, an injunction prohibiting future employment or a forfeiture of an employee plan benefit), “the employee is subject to an economic loss should he breach the restrictive covenant.”<sup>2</sup> Relying on this reasoning, the court analyzed the forfeiture provision in Food Fair’s plan as though it were a traditional non-competition covenant, and ultimately held that its restrictions were unreasonable and, thus, unenforceable. Therefore, Greeley could keep the \$8,514.10 plan benefit and compete with Food Fair.

---

<sup>1</sup> *Food Fair Stores, Inc. v. Greeley*, 264 Md. 105, 285 A.2d 632 (1972). (Note: This case and many other cases cited in this article pre-date the Employee Retirement Income Security Act of 1974 (ERISA), 29 USC §§1001 *et seq.*, which generally requires minimum vesting schedules in tax-qualified retirement plans.)

<sup>2</sup> *Id.*, at 117.

---

\* The author gratefully thanks Tony Miodonka, Esq. and Lindsey E. Mongeon, Esq., attorneys at Finn Dixon & Herling LLP, for their contributions towards this article. © Susan Powell 2009.

## **NON-COMPETITION COVENANTS: THE TRADITIONAL ANALYSIS (STANDARD OF REASONABLENESS)**

A covenant not to compete (or a “non-compete”), whether standing alone or, as is more often the case, embedded within a broader employment agreement, represents the employee’s promise not to engage in competition with his or her employer according to the terms and limits set forth in the agreement. Such a promise, if upheld by a court, is generally enforced by way of an injunction preventing the individual employee from engaging in the competitive activity. However, because an injunction (or threat thereof) limits an individual’s opportunity to be gainfully employed, courts often do not enforce non-competes to the full extent provided in the contract. In some cases, a court will simply refuse to enforce the non-compete altogether. In many other cases, the court will reduce the scope of a non-compete that it considers unreasonable (e.g., reducing a worldwide, lifetime non-compete to one that covers a particular location for a limited period of time).<sup>3</sup> Finally, in certain states, courts will refuse to grant an injunction due to state statutes that render non-compete provisions void as a matter of law.

Courts across the country have developed numerous rules and exceptions when determining whether a particular non-compete is enforceable. The primary considerations in the traditional non-compete analysis generally include: (1) the length of time that the restriction is in effect (i.e., how long the employee must refrain from competition); (2) the size of the geographic area to which the restriction applies (i.e., whether the restraint on competition applies locally, regionally, nationally or internationally); and (3) the nature of the restricted activities. The reasonableness inquiry into individual non-compete covenants calls for a highly fact-sensitive legal analysis. This often makes it difficult to predict whether a court — even one with well-developed and firmly established jurisprudence in this area — will enforce a particular non-compete under a given set of circumstances.

## **ALTERNATIVE APPROACH: FORFEITURE FOR COMPETITION AGREEMENT (“CLAWBACK”)**

Employers seeking to protect their competitive advantage and avoid the unpredictable nature of seeking

injunctive relief are increasingly drafting forfeiture-for-competition provisions, or “clawbacks,” instead of traditional non-competes. The employers hope that the courts will not subject these provisions to the higher scrutiny applied in the traditional non-compete analysis. Unlike traditional non-competes, which flatly prohibit a former employee from accepting certain employment opportunities, forfeiture-for-competition provisions, like the one in *Greeley*, give employees a choice between either receiving and retaining certain benefits (often of significant value) or engaging in competitive activities, and may be an alternate method of influencing employees to not compete.<sup>4</sup> In many cases, an employer will require a former employee to forfeit deferred compensation or income realized from a stock option exercise if the employee competes or otherwise acts contrary to the employer’s interests. As demonstrated by *Greeley*, this approach is often unsuccessful.

## **CASES IN WHICH THE COURT DETERMINED THAT FORFEITURE- FOR-COMPETITION PROVISIONS ARE A RESTRAINT OF TRADE AND SUBJECT TO A TRADITIONAL NON-COMPETE ANALYSIS**

As illustrated in *Greeley*, forfeiture-for-competition provisions do not provide employers with a panacea to the problem of unpredictable non-compete enforceability. In fact, many courts across the country view forfeiture provisions as nothing more than an indirect restraint of trade that must be subjected to the traditional reasonableness analysis originally developed to test the ability to obtain injunctive relief.

In *Greeley*, the court expressed its view that forfeiture-for-competition provisions, due to the value of benefits employees may forfeit if they were to compete, do not really offer employees a choice and, therefore, prohibit competition. In other words, such forfeiture provisions act as an effective restraint of trade and, thus, violate public policy to the extent that they are “unreasonable.” Courts adhering to this view assert that forfeiture-for-competition provisions may be enforced only in accordance with the traditional non-compete analysis.

The *Greeley* approach was confirmed almost 20 years later in a somewhat different context. In *Hollo-*

<sup>3</sup> Alabama: Ala. Code §8-1-1 (1975) (discussed below); California: Cal. Bus. & Prof. Code §16600 (West 2009); Montana: Mont. Code Ann. §28-2-703 (2007); North Dakota: N.D. Cent. Code §9-08-06 (2009); Oklahoma: Okla. Stat. Tit. 15, §217 (2009).

<sup>4</sup> Many employees are subject to both traditional non-competition agreements, pursuant to which an employer may demand injunctive relief, and a clawback. Employers should consider whether a clawback may be viewed as a form of liquidated damages, thereby eliminating the need or ability to obtain injunctive relief.

way v. Faw, Casson & Co.,<sup>5</sup> the court was faced with a forfeiture-for-competition provision contained in a professional partnership agreement. The agreement provided that:

[a]ny partner withdrawing from the partnership voluntarily or involuntarily hereby covenants and agrees that he or she will not engage in the general practice of public accountancy . . . either individually or with any other person, firm or corporation, either directly or indirectly, at any place within a forty mile radius of any of our offices for a period of five years from the date of such withdrawal. If within these limits the partner engages in the general practice of public accountancy . . . he or she agrees to pay Faw, Casson & Co. ["FC"] or its successor, 100% of the prior year's fee for any clients that were Faw, Casson & Co.'s who engage the services of the withdrawing partner during the five year period.<sup>6</sup>

The plaintiff, Robert E. Holloway, withdrew from FC and joined a competing firm, taking with him at least 171 of his former partnership's clients.<sup>7</sup>

Understandably, FC sought to enforce its rights under the partnership agreement and recoup some of its more than \$95,000 in alleged damages. In addition to withholding money owed to Holloway under a post-termination deferred compensation plan, FC sought damages as provided by the forfeiture provision in the partnership agreement. Although the court noted that FC never attempted to enjoin Holloway from competing, and had disclaimed that such a remedy was available under the partnership agreement, it nevertheless concluded, in conformity with the holding of *Greeley*, that "[t]he [forfeiture-for-competition] covenants in [the partnership agreement] are sufficiently similar to covenants not to compete to invoke, in general, the analysis applied under the law bearing on covenants not to compete."

Fortunately for FC, the court determined that the non-competition covenant was reasonable. Interestingly, the court considered the following in its reasonableness analysis: Holloway was not, in fact, restrained in any way from competing with FC, with the exception of working for clients that FC was servicing at the time of Holloway's departure. The court noted that: "If that occurs, then the Agreement says that Holloway is obliged, in effect, to purchase the ac-

count from his former firm."<sup>8</sup> This fact — which is really the essence of a forfeiture provision and the reason many courts treat such provisions differently from traditional non-competes — was pivotal in the court's conclusion:

The covenant in the Agreement, as limited by the fee equivalent remedy, ties the restriction closely to FC's interest in its client base, inhibits Holloway's practice of accountancy only with respect to that client base, and gives the general public, outside of that client base, the benefit of unfettered competition. The reasonableness of the provision is further reinforced by its ready analogy to the purchase of an accounting practice, or of part of an accounting practice.<sup>9</sup>

In *Pollard v. Autotote, Ltd.*,<sup>10</sup> the Third Circuit, applying Delaware law, held that the legal standard applied to traditional non-competes is appropriate for forfeiture-for-competition provisions as well. Pollard was an employee and participant in Autotote's incentive plan providing for deferred compensation. The plan stated that if Pollard went to work for a competitor, he would forfeit his rights to the deferred portion of his plan. Autotote terminated Pollard's employment, and he eventually went to work for a competitor of Autotote. Autotote refused to pay Pollard the deferred portion of his compensation plan because Pollard was working for a competitor. The court, siding with Pollard, explained its reasoning: ". . . a covenant not to compete and a forfeiture-for-competition clause each restricts an employee's ability to accept alternate employment. . . ." <sup>11</sup> Thus, by considering the term "restrict" in a broad sense, the court concluded that, merely by providing a strong contractual incentive for Pollard not to compete, Autotote had acted to restrict trade and was, therefore, subject to the heightened scrutiny of the traditional non-compete analysis.

In *Deming v. Nationwide Mutual Insurance Co.*,<sup>12</sup> the Supreme Court of Connecticut held that a forfeiture-for-competition provision involving "substantial sums of money" was a restraint against competition to which the traditional non-compete analysis applied, even though it had not applied the traditional non-compete analysis to a similar covenant in a prior

<sup>5</sup> 319 Md. 324, 572 A.2d 510 (1990).

<sup>6</sup> *Id.*, at 327–28.

<sup>7</sup> *Id.*, at 327.

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*, at 343–44.

<sup>10</sup> 852 F.2d 67 (3d Cir. 1988).

<sup>11</sup> *Id.*, at 71.

<sup>12</sup> 279 Conn. 745, 762 (2006).

case.<sup>13</sup> In *Deming*, an insurance company's deferred compensation plan required its sales employees to forfeit hundreds of thousands of dollars in commissions and deferred compensation that had been earned over the course of their entire careers in exchange for their choice to compete. The court, while declaring that "the fact of the amount of the forfeiture should not determine the category of the condition, but, rather, should become a relevant consideration as to the reasonableness of that condition,"<sup>14</sup> nevertheless concluded that "[t]he total prohibition against competition, enforced by a forfeiture of accrued benefits, subjecting the employee to an economic loss undoubtedly is designed to deter competition."<sup>15</sup> Although perhaps influenced by the amount of money to be forfeited under the forfeiture clause, the court was certainly not ambiguous in articulating the basis for its approach:

Permitting a forfeiture clause that is not subject to a reasonableness assessment is essentially no different than enforcing a covenant not to compete, which, not properly circumscribed, is the classic example of a direct restraint. We would be unduly formalistic if we were to invalidate a covenant not to compete that was in direct restraint of trade, but approve a forfeiture provision that indirectly accomplished the same result.<sup>16</sup>

The high courts in several other states have also concluded that forfeiture-for-competition provisions must withstand the test of reasonableness. For instance, in *Lavey v. Edwards*,<sup>17</sup> the Supreme Court of Oregon faced a forfeiture-for-competition provision embedded in a non-contributory "profit-sharing retirement plan."<sup>18</sup> The forfeiture provision at issue was unconstrained by any temporal or geographic limitations, and the defendant employer argued that "regardless of the validity or invalidity of such non-competition clauses in employment contracts, provisions for the forfeiture of benefits under noncontributory profit-sharing pension plans when an employee accepts employment by a competitor are valid even though such clauses are without limitation as to time or territory."<sup>19</sup>

The court recognized the line of authority cited by the defendant in support of this argument, noting:

---

<sup>13</sup> *Schoonmaker III v. Cummings and Lockwood of Connecticut*, 252 Conn. 416 (2000).

<sup>14</sup> 279 Conn. 745, 762, n.17.

<sup>15</sup> *Id.*, at 767.

<sup>16</sup> *Id.*, at 768.

<sup>17</sup> 264 Or. 331, 505 P.2d 342 (1973).

<sup>18</sup> *Id.*, at 332.

<sup>19</sup> *Id.*, at 334.

Most of these cases adopt the view that such a provision is not a prohibition on the employee engaging in competitive work, but is "merely" a denial of his right to participate in the pension plan if he does so engage and that the employee has a "choice" under which he may decide whether or not to engage in competitive work, which he is "free" to do even though, as a result, he may risk losing the benefits of a pension plan to which he has contributed nothing.<sup>20</sup>

Rejecting this reasoning, the Oregon court was persuaded by critics of this approach, asserting that:

even under noncontributory pensions plans, benefit payments are no longer regarded as "gratuities," but as a contractual right to deferred compensation, and that these decisions ignore the inhibitory effect of such a forfeiture clause upon an employee in making the decision whether to accept a new job, in that ordinarily the new employment will not compensate him for the loss of the pension, which may represent a substantial portion of what he must depend upon when he retires and which he cannot risk by competing.<sup>21</sup>

The court ultimately remanded the case, instructing the trial court to subject the contested forfeiture provision to a traditional reasonableness analysis.<sup>22</sup>

Two years after *Lavey* was published, the Supreme Court of Washington followed the Oregon court's lead in *Sheppard v. Blackstock Lumber Co., Inc.*<sup>23</sup> In *Sheppard*, the court was faced with a "Forfeiture for Detrimental Activities" provision in the employer's profit-sharing retirement plan. The plaintiff, a former employee of Blackstock, was advised by letter of the potential consequences of his competitive activities, and subsequently brought an action seeking to restrain Blackstock from enforcing the forfeiture provision. The trial court granted summary judgment for the employer, and Sheppard appealed, "contending that the forfeiture provision is unenforceable as an impermissible restraint of trade."<sup>24</sup>

The court agreed that the forfeiture provision amounted to a restraint of trade, notwithstanding the options available to the former employee:

The forfeiture clause is indeed an inhibitive influence on an employee's decision whether

---

<sup>20</sup> *Id.*, at 336-37.

<sup>21</sup> *Id.*, at 337.

<sup>22</sup> *Id.*, at 339-40.

<sup>23</sup> 85 Wash.2d 929, 540 P.2d 1373 (1975).

<sup>24</sup> *Id.*, at 930.

to accept a new job. . . . However, we do not consider such clauses void and invalid per se, but agree with the *Lavey* court that validity of such clauses should be determined as is the validity of a noncompetition clause in an employment contract — by a test of reasonableness.”<sup>25</sup>

The matter was remanded “for the purpose of determining to what extent, if any, the forfeiture provision provides a reasonable restraint and to what extent it may be enforceable.”<sup>26</sup>

The Massachusetts Supreme Court followed suit in 1979 with its decision in *Cheney v. Automatic Sprinkler Corp. of America*.<sup>27</sup> The litigants in *Cheney* were parties to an employment contract that included a forfeiture-for-competition provision that was tied to certain deferred payments that the employee forfeited if he joined a competitor.<sup>28</sup> Despite noting that “the majority view in this country seems to be that a forfeiture-for-competition clause in an employment agreement is enforceable without regard to the reasonableness of the restraint on the former employee,”<sup>29</sup> the court nonetheless rejected the “suggestion that an employee in a case such as this has made an agreement to which he must be held in all instances.”<sup>30</sup>

The Massachusetts court indicated that one of the driving factors in its conclusion was its view of the relative status of the contracting parties:

Agreements of the character involved here often are not arrived at by bargaining between equals. The employer normally presents the terms on a “take it or leave it” basis. This is particularly true where, as here, an annual agreement is presented to an employee whose options are to sign or to terminate his employment.<sup>31</sup>

This approach was more recently reaffirmed without comment in *Securitas Security Services USA, Inc. v. Jenkins*.<sup>32</sup>

<sup>25</sup> *Id.*, at 932.

<sup>26</sup> *Id.*, at 934.

<sup>27</sup> 377 Mass. 141, 385 N.E.2d 961 (1979).

<sup>28</sup> *Id.*, at 142–43.

<sup>29</sup> *Id.*, at 145.

<sup>30</sup> *Id.*, at 147.

<sup>31</sup> *Id.*

<sup>32</sup> 16 Mass. L. Rptr. 486, 2003 WL 21781385 \*12 (Mass. Super. 2003) (“The non-competition aspects of [the employee’s] Agreement with [plaintiff-employer] appears to this Court to be a forfeiture-for-competition clause. As such it does not absolutely proscribe competition by [the employee]. It merely makes it eco-

Courts in California and North Dakota, two of the states that generally invalidate non-competes by law,<sup>33</sup> have applied their statutes to forfeiture-for-competition provisions. In *Muggill v. Reuben H. Donnelley Corp.*,<sup>34</sup> the California Supreme Court was faced with the issue of whether a contract that terminated certain retirement benefits if a former employee engaged in competition with his former employer was valid under its statute, which provides that “every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void.”<sup>35</sup> The court concluded that the provision was unenforceable. “This [statute] invalidates provisions in employment contracts prohibiting an employee from working for a competitor after completion of his employment *or imposing a penalty if he does so.*”<sup>36</sup> Under a functionally identical statute, the Supreme Court of North Dakota reached the same conclusion:

The contract restrains Werlinger [the employee] from competing with MSI [the employer] by requiring that he “purchase the freedom” to compete with MSI by forfeiting money that MSI would otherwise pay to him. The contract restrains Werlinger from competing with MSI by “imposing a penalty if he does so” in the form of a forfeiture of money otherwise due him if he should elect to compete with MSI.<sup>37</sup>

## FORFEITURE-FOR-COMPETITION PROVISIONS DISTINGUISHED: NO PROHIBITION, NO RESTRAINT

Not all courts disregard the distinction between standard non-compete covenants and incentive-driven forfeiture provisions. Indeed, there is a strong current of authority supporting the proposition that such provisions are perfectly legitimate and may be enforced if valid under existing contract law principles.

In general, courts adhering to the contract approach focus on the fact that forfeiture-for-competition provisions involve *choice*. That is, the employee has the choice of competing and forfeiting benefits or retain-

nomically costly for him to do so. Of course, Massachusetts courts must apply the same test of reasonableness to a forfeiture-for-competition clause as to a non-competition clause.” (citing *Cheney*, above)).

<sup>33</sup> California: Cal. Bus. & Prof. Code §16600 (West 2009); North Dakota: N.D. Cent. Code §9-08-06 (2009).

<sup>34</sup> 62 Cal.2d 239, 398 P.2d 147, 42 Cal. Rptr. 107 (1965).

<sup>35</sup> Cal. Bus. & Prof. Code §16600 (West 2009).

<sup>36</sup> *Muggill*, 62 Cal.2d at 242 (emphasis added).

<sup>37</sup> *Werlinger v. Mutual Service Casualty Ins. Co.*, 496 N.W.2d 26, 30 (N.D. 1993) (emphasis added; internal citations omitted).

ing benefits and forfeiting the right to compete. Thus, forfeiture-for-competition provisions are enforceable without regard to the traditional non-compete analysis because they offer employees the choice to compete. In other words, and perhaps stated more accurately, there is no restraint on trade because there is no direct *restraint* of the employee's ability to ply his or her trade in the manner he or she sees fit. Presumably, employees acting rationally engage in a measured cost-benefit analysis, weighing the benefit of competitive employment against the cost of forfeiture. The product of this analysis, whatever it may be, is the result of a bargained-for exchange, and the court has no license to interfere absent some applicable principle of contract law.

Courts in North Carolina, for example, have evaluated forfeiture-for-competition provisions under general contract principles, and have enforced them to the extent they are part of an otherwise valid contract. One illustrative case is *Eastern Carolina Internal Medicine, P.A. v. Faidas*,<sup>38</sup> a case concerning a liquidated damages provision in the defendant's employment contract that became payable in the event that the defendant, a physician employed by the plaintiff, engaged in the practice of medicine within certain defined geographic limits after leaving the plaintiff's employ. This case provides an interesting contrast with the factually similar *Holloway* case, discussed above.

The "cost-sharing" provision at issue in *Faidas* provided that, should the defendant violate the non-compete clause in the contract, she would be required to "share" the plaintiff's cost of recruiting and subsequently replacing her, as well as the estimated loss of revenue associated with her departure to a competitive provider. The cost-share amount, which essentially operated as a liquidated damages provision, was calculated as follows:

The Total Operating Expense of Employer for the fiscal year of Employer immediately preceding the date of termination of employment as reflected on the fiscal year-end financial statements of Employer shall be divided by the number of full-time equivalent physician-employees of Employer during such fiscal year, and . . . [t]he quotient then shall be multiplied by twenty-five percent (25%) with the product being the Cost Share amount.<sup>39</sup>

In this way, the employment agreement sought to quantify the cost of losing a physician to a competitor

and tie that cost to a liquidated damages provision that would provide an incentive for its employee not to compete.

The defendant argued that the cost-sharing provision was "void as an unreasonable restraint of her trade and against public policy."<sup>40</sup> The court disagreed, concluding that:

[t]he Contract does not prohibit defendant from engaging in the practice of her profession, but only provides that if she does so within the described three county area, she will pay a certain sum for making this choice. Accordingly, we hold that the "Cost Sharing" provision is not a covenant not to compete and we do not subject it to the strict scrutiny as to reasonableness and public policy required with a covenant not to compete.<sup>41</sup>

The majority in *Faidas*, unlike Judge Wynn in dissent, was not impressed by the fact that, unlike in prior cases, the defendant employee was required to pay money to the employer upon breaching the non-compete covenant, rather than merely having funds that would otherwise be due to the employee withheld. The majority of the court was persuaded that the rationale underlying its past refusal to treat forfeiture-for-competition provisions like traditional non-competes — employee choice — remained intact regardless of the mechanics of the penalty for exercising the choice to compete (short of injunction, presumably).<sup>42</sup>

Several federal cases have adopted this approach. See, e.g., *Rochester Corp. v. Rochester*.<sup>43</sup>

The strong weight of authority holds that forfeitures for engaging in subsequent competitive employment, included in pension retirement plans, are valid, even though unrestricted in time or geography. The reasoning behind this conclusion is that the forfeiture, unlike the restraint included in the employment contract, is not a prohibition on the employee's engaging in competitive work but is merely a denial of the right to participate in the retirement plan if he does so engage.

<sup>40</sup> *Id.*, at 944.

<sup>41</sup> *Id.*, at 945; see also *Newman v. Raleigh Internal Medicine Associates*, 88 N.C. App. 95, S.E.2d 623 (1987); *Hudson v. North Carolina Farm Bureau Mut. Ins. Co.*, 23 N.C. App. 501, 209 S.E.2d 416 (1974), *cert. denied*, 286 N.C. 414, 211 S.E.2d 217 (1975). *Note*: It does not appear that the North Carolina Supreme Court has yet had occasion to consider this issue, but its denial of certification in *Hudson* may be viewed as an indication of its approval of the appellate court's approach.

<sup>42</sup> *Faidas*, 149 N.C. App. at 945.

<sup>43</sup> 450 F.2d 118, 122–23 (4th Cir. 1971).

<sup>38</sup> 149 N.C. App. 940, 564 S.E.2d 53 (2002).

<sup>39</sup> *Id.*, at 943–44.

See also *Johnson v. MPR Associates, Inc.*<sup>44</sup> (same analysis with respect to a stock transfer agreement). In *Fraser v. Nationwide Mutual Ins. Co.*,<sup>45</sup> the Federal District Court for the Eastern District of Pennsylvania articulated a persuasive line of reasoning based on its perception of the rationality of the various parties to a transaction of this sort, when each has the freedom to act in its best interest. The court explained:

Nationwide did not impede Fraser from working for another company by threat of injunction — rather, Fraser was simply faced with the decision of whether or not to disqualify himself from a monetary benefit. In all likelihood, Fraser made that decision as any rational actor would — by weighing the benefits and losses attributable to each option.<sup>46</sup>

Thus, the court enforced the forfeiture provision as it would any other freely negotiated contractual provision.

In *Lucente v. IBM*,<sup>47</sup> the Second Circuit analyzed a forfeiture-for-competition provision under New York’s “employee choice doctrine,” which allows restrictive covenants to be enforced without regard to the traditional non-compete analysis when an employee is given a choice between competing and losing certain benefits or not competing and receiving or keeping certain benefits. Lucente, an IBM executive, retired from IBM after 30 years, and two years later went to work for an alleged competitor. The forfeiture provisions in his stock option agreements stated, without regard to geographic region or time frame, that his stock options would be cancelled if he worked for a competitor after his employment with IBM. Although the court did not set forth the exact criteria of the employee choice doctrine, it noted that the employer must be able to prove that it was willing to continue to employ the relevant employee, and that the doctrine does not apply if the employee was involuntarily terminated. In this particular instance, the court remanded the case for a determination as to whether Lucente’s termination was involuntary.

A fairly acute example of the theory that a restraint-on-trade argument can be completely defeated by choice comes from the state of Alabama. An Alabama statute, Ala. Code §8-1-1 (1975), declares: “Every contract by which anyone is restrained from exercising a lawful profession, trade, or business of any kind

otherwise than is provided by this section is to that extent void.”<sup>48</sup> Despite the strength and seeming clarity of this statement, Alabama courts have concluded that forfeiture-for-competition provisions do not fall within the statute’s purview. In *Southern Farm Bureau Life Insurance Company v. Mitchell*,<sup>49</sup> the court upheld a contractual provision whereby the employee forfeited his right to receive renewal commissions if he began working for another insurance company in the state of Alabama. The court pointed out that the parties were not “dealing with an anti-competitive agreement prohibited by section 8-1-1 but rather with a forfeiture clause.”<sup>50</sup> According to the court,

the rationale for upholding forfeiture clauses in competitive situations has been the fact that such contracts are supported by sound business practice. The contract involved in the instant appeal did not in any way prevent Mitchell from engaging in the business of selling insurance. The record before us indicates that Mitchell did, in fact, work for other companies after he left Southern Farm Bureau.<sup>51</sup>

In an earlier case, *Courington v. Birmingham Trust National Bank*,<sup>52</sup> the Supreme Court of Alabama stated that the predecessor statute to §8-1-1 “was inapplicable to the forfeiture provision because it did not “restrain” the employee from “exercising a lawful profession.” The court explained:

the situation before us . . . clearly does not involve a restriction upon the employee’s entry into a competitive endeavor. Here, the former employer [sic] is not prevented from earning a living. . . . If the participating employee wishes to leave his employment, he is free to do so, and if he leaves for another position, he loses none of his accrued benefits, unless by electing to enter a competitive enterprise he makes the choice to lose that portion contributed by his former employer who must continue to offset the effect of his competition with it in order to continue the Plan for the benefit of those who remain.<sup>53</sup>

<sup>44</sup> 894 F. Supp. 255, 257 (E.D. Va. 1994).

<sup>45</sup> 334 F. Supp.2d 755 (E.D. Pa. 2004).

<sup>46</sup> *Id.*, at 760.

<sup>47</sup> 310 F.3d 243, 254 (2d Cir. 2002).

<sup>48</sup> There are two narrow exceptions in the statute to this restriction that are not relevant to this discussion.

<sup>49</sup> 435 So.2d 745 (Ala. Civ. App. 1983).

<sup>50</sup> *Id.*, at 748.

<sup>51</sup> *Id.*

<sup>52</sup> 347 So.2d 377 (Ala. 1977).

<sup>53</sup> *Id.*, at 383.

## WHERE DO WE GO FROM HERE?

As illustrated by the case law discussed above, there is no uniform test or bright-line rule with respect to the enforceability of forfeiture-for-competition provisions. Additionally, as the *Deming* case particularly indicates, the specific facts and circumstances surrounding a forfeiture-for-competition provision (e.g., the amount of money subject to forfeiture) may play a role in whether a court chooses to subject that particular provision to the traditional non-compete analysis. Another factor to consider is that, although non-competes are often written with a particular jurisdiction in mind, there is no guarantee that the law of such jurisdiction will apply — i.e., employees relocate. Although the employee may have begun employment in a state that does not apply a traditional non-compete analysis to a clawback, when an employee is competing in a new employer's state, the courts will often apply the law of the new state to determine whether the non-compete is enforceable.

These factors are particularly troublesome because forfeiture-for-competition provisions are not often drafted with the same considerations and limitations in mind as traditional non-competes. Thus, to the extent that the court finds the forfeiture provision unreasonable, it may not be able or willing to salvage the provision by modifying or striking the overbroad restriction and enforcing the “reasonable” remainder.

One avenue for relief may be through the use of a so-called “top hat” deferred compensation plan that is governed by ERISA. An ERISA top hat plan, by definition, provides retirement benefits to a select group of management and highly compensated employees.<sup>54</sup> Unlike the rules that apply to ERISA tax-qualified retirement plans, retirement benefits under a top hat plan, even if “vested” under a service-based or other schedule, can be forfeited. Additionally, and most importantly for this analysis, ERISA preempts state law.<sup>55</sup>

---

<sup>54</sup> 29 USC §1051(2).

<sup>55</sup> 29 USC §1144. Employers may also consider the use of a severance plan governed by ERISA. See *Tracz v. Pfizer, Inc.*, 2004 WL 1445961 (E.D. Pa. 6/25/04) (contract claims relating to severance plan were preempted by ERISA).

Many courts have concluded that ERISA preempted state common law rules regarding forfeiture-for-competition agreements contained in an ERISA retirement plan. For example, in *Lindsay v. Cottingham & Butler Ins. Services, Inc.*,<sup>56</sup> the Supreme Court of Iowa held that “ERISA’s failure to protect top hat plans from the forfeiture provisions contained in those plans allows a top hat plan to include enforceable noncompete forfeiture provisions even if these provisions are not enforceable under state law.”<sup>57</sup> See also *Clark v. Lauren Young Tire Center Profit Sharing Trust*,<sup>58</sup> in which the Ninth Circuit, considering a forfeiture provision under Oregon law, similarly held that “ERISA preempts state law with respect to non-competition forfeiture clauses”; and *Scala v. CC Industries*,<sup>59</sup> in which the court determined that ERISA governed, state law did not apply, and that the plan benefits were properly forfeited pursuant to the terms of the plan.

Of course, a top hat plan will not work in many situations. Although many employers seek the return of bonuses and stock options, top hat plans only apply to deferred compensation benefits, and the plan can only cover a select group of high-level employees. Also, whether a plan qualifies as a top hat plan under ERISA is heavily litigated, which adds an additional level of risk to this approach.

In light of the uncertainty inherent in non-compete cases, and that, for business reasons, top hat plans will not provide the solution in many instances, forfeiture-for-competition provisions should be evaluated and drafted carefully and should not be viewed by employers as a simple solution to the uncertainty of the traditional non-compete analysis.

---

<sup>56</sup> 763 N.W.2d 568 (Iowa 2009).

<sup>57</sup> *Id.*

<sup>58</sup> 816 F.2d 480, 481 (9th Cir. 1987).

<sup>59</sup> 1995 WL 522880 (E.D.N.Y. 8/18/95).