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# NEWS



# BUSINESS LAW

## LETTER

### MSBA SECTION OF BUSINESS LAW

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## Judicial Revision of Non-Competition Covenants: Drastic Change or Steady as She Goes?

By Allan P. Hillman

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An issue which often arises in determining whether a post-term non-compete covenant is enforceable is whether, if the non-compete is held overbroad in duration or geographic area, or in breadth of restraint as to customers, it nevertheless will be enforced in part. Further, if partial enforcement is permissible under state law, will the court rewrite the covenant to make it reasonable, or will it merely “blue pencil” the covenant. In blue penciling, a court may only change the covenant by crossing out words and phrases that are unnecessarily broad – but by inserting nothing and changing no existing words – and the court then enforces what remains, if anything intelligible remains. In addition, Maryland courts have indicated that, where there are a multitude of separate covenants, a court may sever an offending covenant and enforce the non-offending covenants. *Deutsche Post Global Mail Ltd. v. Conrad*, 292 F.Supp.2d 748, 754 (D. Md. 2003); *Tawney v. Mutual System of Maryland*, 186 Md. 508 (1946).

Finally, there is some point at which a covenant is so unreasonable and overreaching that a court may withhold its assistance and will decline even to enforce a more limited restraint by means of blue penciling. The question is to what degree a court will require parties to live by the contracts they signed, and to what degree a court will assist an employer which seeks to obtain unfair advantage by foisting a vastly overbroad restraint on the ex-employee. There is a limit beyond which a Maryland court will not go. See *Holloway v. Faw, Casson & Co.*, 78 Md. App. 205, 235-38 (1989), *affirmed on other grounds*, 319 Md. 324 (1990).

An example will illustrate these issues. Suppose a covenant states that a salesperson will not, for three years after the termination of her appointment,

compete with her ex-employer in Baltimore, Howard, and Carroll counties. If a court decided the covenant was overbroad as to geographic area, it could blue pencil it by crossing out one or two of the counties, and enforcing the remaining geographic area. If the Court found it was overbroad as to duration, however, it could not change the covenant by blue penciling, since to cross out the word “three” would be to leave no duration at all. The court would have to be willing to rewrite the covenant.

If, on the other hand, the employee had worked in Baltimore City and was restricted from competing in the entire United States, a court might decide that the

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## Judicial Revision . . .

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employer had been so unreasonable as to be unjust, and could refuse to enforce any covenant at all.

The states differ significantly here. Some treat a covenant as enforceable only as written and refuse to rewrite or blue pencil. In those states, it is *caveat emptor* for the drafter. At the other end of the continuum, some states (and noted commentators) advocate full rewriting of covenants to make them reasonable, with the proviso that some covenants may be so offensive that a court will not assist the drafter. Finally, some states fall into the middle ground, in which a court will blue pencil a covenant, but will not rewrite a covenant.

Maryland has had an inconsistent history in this regard. The State is generally favorable to covenants not to compete. Some early cases indicated a willingness to blue pencil, and a 1989 Court of Special Appeals' decision indicated a willingness to rewrite except in limited circumstances. See *Holloway, supra*. (*Holloway* discusses in depth the history of this issue in Maryland.)

The Court of Special Appeals in *Holloway* explained:

Despite the several valid criticisms leveled at the flexible approach we are convinced that, on the whole, the numerous justifications underlying this method outweigh the consideration behind the formalistic strict blue pencil approach and we adopt the position taken by Professors Williston and Corbin, *supra*, as the law in this State....

\* \* \*

The gist of the test applied in the cases and treatises, *supra*, which support the flexible approach is essentially a **two part inquiry**: (1) Does the restrictive covenant as a whole evidence a **deliberate intent by the employer to place unreasonable and oppressive restraints on the employee/covenantee**? If so, then the entire covenant is invalidated, whether severable or not. (2) If the agreement, although unreasonable, satisfies the [protectable interest] test in part 1, then the court should modify the express terms so as to align the reasonable expectations of the parties to the reasonable expectations of the law, so long as it is fair to do so.

78 Md. App. at 237-38 (emphasis added). However, the Court of Appeals expressly did *not* have to "reach the

question of partial enforcement, in the sense in which the panel majority used and applied it, [because] the invalidity [was] severable." *Holloway*, 319 Md. at 353. It expressly declined to reach the issue of whether a Maryland court could *rewrite* a covenant.

From the above, and later decisions, there is no doubt that blue penciling is permitted. See *Fowler v. Printers II, Inc.*, 89 Md. App. 443, 465-66 (1991). And it appeared that the Court of Special Appeals' ("COSA's") language in *Holloway*, unless subsequently rejected, when considered in a different case by the Court of Appeals, might permit rewriting unreasonable covenants under circumstances in which the employer has dealt in good faith. *Holloway*, 319 Md. at 353.

In 2003, however, the United States District Court for the District of Maryland held squarely that Maryland law permitted blue penciling but *not* rewriting of a covenant. Because that was so, the Court refused to redraft a covenant (refusing to supplement or re-range language), and, when the Court merely blue penciled it, the resulting covenant was still held overbroad and unenforceable. The court expressed special concern over allowing employers to draft overbroad covenants as an *in terrorem* tactic, and then to rely on the courts to enforce whatever was lawful. In fact, the Court expressly criticized even blue penciling at all. The case is *Deutsche Post Global Mail, Ltd. v. Gerard Conrad*, 292 F.Supp.2d 748 (D. Md. 2003), and Judge Motz' comments are instructive:

In my view to permit blue penciling encourages an employer to impose an overly broad restrictive covenant, knowing that if the covenant is challenged by an employee, the only consequence suffered by the employer will be to have a court write a narrower restriction for it. This appears to me to be extremely unfair and contrary to sound public policy. Cf. *Trailer Leasing Co. v. Associates Commercial Corp.*, 1996 WL 392135 at \*4 (N.D. Ill., July 10, 1996); *Telxon Corp. v. Hoffman*, 720 F.Supp. 657, 666 (N.D. Ill. 1989).

\* \* \*

[Nevertheless,] Maryland law permits courts to remove unnecessarily broad language from restrictive covenants to make them enforceable, as long

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as the remaining language need not be reorganized or rewritten.

\* \* \*

In the present case, the strict divisibility approach permits me to strike section 5(a)(iii) of Conrad and Gemmill’s restrictive covenants and the over-broad portions of section 5(a)(ii), as described in Section III *supra*. However, it does not allow me to add words limiting the solicitation provision so as to apply only to those customers that Conrad and Gemmill had contact with, or alternatively, to customers within the United States. Accordingly, Defendants are entitled to the summary judgment they seek.

*Id.* at 754 n.3, 756-58. Judge Motz reviewed the COSA’s *Holloway* opinion and the approaches it took to blue penciling. He said that the alternatives available to him to avoid blanket restrictions “prohibiting the direct or indirect solicitation or diversion of DGM customers, as well as attempted solicitation or diversion” would require him to *rewrite* the agreement, however. *Id.* at 757. The suggestion to limit the restriction to customers “with whom Conrad and Gemmill had contact” would be an impermissible rewriting. Pointing out that the COSA’s

*Holloway* opinion explained two theories and the Court of Appeals did not reach the issue, Judge Motz said opinions prior to the COSA’s *Holloway* decision “persuade me that blue penciling must be limited to the removal of offending language and *cannot include the addition of words or phrases* in an effort to make the restrictive covenant reasonable.” *Id.* at 757-58. (emphasis added.)

As a result, the safe rule is to have carefully drafted covenants, limited in duration to two years or less, and limited in area usually to the area in which and/or customers with whom a salesperson interacted. In some limited cases, much broader restrictions may be justified, *see, e.g., Intelus Corp. v. Barton*, 7 F.Supp.2d 635 (D. Md. 1998); but, if so, it is best to have several separate restrictions which are expressly divisible so that the whole edifice does not fall if one restraint falls.

In the end, the essential test of lawfulness is whether the scope of a restriction is reasonable from the point of view of the employer while not unduly prejudicing the ex-employee. *Holloway*, 319 Md. 324, 334 (1990); *Tabs Associates Inc. v. Brohawn*, 59 Md. App. 330 (1984); *see Becker v. Barley*, 268 Md. 93 (1973); *Ruhl v. Bartlett Tree Expert Co.*, 245 Md. 118 (1967). Ask your clients what protection they *really* need – and why – and draft for the real world, not the world in which they wish they existed. It is the real world you will confront in court.

**Is Mandatory Disclosure of Professional Liability Insurance Coverage Coming to Maryland?**

*By Deborah H. Diehl, Esq. and Mustafa Kamal, Esq.  
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**Background**

At the August, 2004 Annual Meeting of the American Bar Association, on the recommendation of the ABA Standing Committee on Client Protection, the ABA House of Delegates adopted the Model Court Rule on Insurance Disclosure. This follows action by an increasing number of jurisdictions either mandating a minimum level of professional liability insurance or requiring various forms of disclosure to clients with respect to whether a specified minimum level of insurance is maintained.

The Business Law Section Council has learned that the MSBA Board of Governors recently voted to oppose adoption of the ABA Model Rule in Maryland; the Maryland Court of Appeals will likely discuss

whether to forward the Model Rule to its Rules Committee for consideration. We make you aware of the issue so that you can provide your own input on the topic to the Rules Committee if the Maryland Court of Appeals determines to further consider the issue.

The ABA Model Rule requires lawyers to disclose on their annual registration statements whether they maintain professional liability insurance. The full text of the ABA Model Rule and the Committee Report recommending its adoption can be found at <http://www.abanet.org/cpr/client.html>. The Committee Report states that “the purpose of the Rule is to provide a potential client with access to relevant information related to a lawyer’s representation in order to make an informed

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decision about whether to retain a particular lawyer...[w]hile the Model Court Rule does not require a lawyer to disclose directly to clients whether insurance is maintained or to maintain professional liability insurance, it does impose a modest annual reporting requirement on the lawyer. The information reported by lawyers will be made available by such means as designated by the highest court in the jurisdiction.”

Alaska, New Hampshire, Ohio and South Dakota have amended their Model Rules of Professional Conduct to require lawyers to disclose to their clients whether they maintain professional liability insurance. Alaska further requires that a lawyer inform clients in writing if the lawyer does not maintain liability insurance with limits of at least \$100,000 per occurrence and a \$300,000 annual aggregate. A lawyer in Alaska must also maintain disclosure records for six years from the termination of representation.

In Ohio and New Hampshire, lawyers must inform clients at the time of engagement or at any later time if the lawyer does not maintain professional liability insurance of at least \$100,000 per occurrence and \$300,000 in the aggregate. A form must be signed by the client acknowledging such notice by the lawyer, and the lawyer must maintain a copy of the notice for five years following the termination of representation.

South Dakota has one of the most comprehensive rules for liability insurance reporting. If a lawyer does not have professional liability insurance with limits of at least \$100,000, or if during the course of representation the coverage lapses or is terminated, a lawyer in South Dakota must promptly disclose this fact to the client as a component of the lawyer’s letterhead.

Delaware and Michigan require lawyers to disclose on their annual certification to the state Supreme Court whether they maintain professional liability insurance, and Nebraska, North Carolina, Virginia, and Illinois require lawyers to disclose on their annual registration statement with the state bar association whether they maintain professional liability insurance. In Nebraska and Virginia, information regarding a lawyer’s professional liability insurance is made available to a potential client if the client contacts the bar association and requests it. Like Virginia, the Illinois Supreme Court will make insurance information available to the public on its website.

Oregon has the strictest requirement in that it mandates professional liability insurance as a condition of practicing law. In Oregon, coverage is tied to a mandatory carrier formed by the state, and the state requires all attorneys in private practice not only to have this

insurance but also to obtain coverage from the bar’s own malpractice insurance fund. Nevada has also amended its Rules of Professional Conduct to require attorneys who advertise as specialists to carry at least \$500,000 of malpractice insurance.

Several other state courts have pending proposals for mandatory liability insurance reporting, as this issue has generated considerable discussion in bar associations across the country. Some states have formed their own insurance companies to compete with commercial insurers, with several bar-related insurance companies offering malpractice coverage to lawyers in different states. The ABA Model Rule is patterned after the reporting requirements in some of the above-mentioned jurisdictions.

### **The Pros and Cons of Insurance Reporting and Maintenance Requirements**

Proponents of the insurance reporting and maintenance requirements believe that whether a lawyer maintains professional liability insurance or another form of adequate financial responsibility is a material fact that may bear upon a client’s decision to hire a lawyer. They state that lawyers should be required to make this information available to prospective clients so that clients can make a fully informed decision when choosing whether to hire a lawyer. Such proponents argue that clients often assume that a lawyer is required to maintain malpractice insurance and do not even think to inquire if the lawyer is covered.

Supporters of such requirements believe that these rules would provide potential clients with the ability to independently determine whether a lawyer maintains professional liability insurance. This is seen as especially important in an industry where clients often have no guaranteed method of gaining financial restitution from an attorney in a malpractice suit and the ability of client protection funds to compensate clients is often limited. Proponents say that professional liability insurance ensures that a client has financial redress against his lawyer. They also claim that most practicing lawyers carry insurance, so it is not an undue burden on the profession, and that most lawyers favor either mandatory disclosure or mandatory coverage.

Detractors of these requirements point out that whether or not a lawyer carries malpractice insurance is not an ethical or moral question, and that a disciplinary system should not be invoked to solve a problem that is

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neither moral nor ethical. Some commentators say that while buying insurance is unquestionably a “best practice” in most situations, it is not one that involves an ethical underpinning. They question the need for such an insurance reporting or maintenance rule, asking for evidence that uninsured lawyers are currently harming clients or pointing out that there is no evidence of malpractice judgments that are uncollectible due to lack of insurance. They also point out that there is no objective data showing that a lawyer who has insurance is more likely to act ethically than one who has none.

Opponents also argue that mandatory coverage takes away the independence and self-regulation from lawyers and puts it in the hands of professional liability insurers; because lawyers who choose not to carry insurance fear losing market share to those who do carry it, insurance companies will have a say in who can compete in the legal marketplace. Another argument brought forth against the proposals is that because of the nature of lawyer’s professional liability insurance, it may be useless, or even misleading, for a client to know that a lawyer has insurance because claims are frequently not made in the same year that a negligent act occurs, and if a lawyer has insurance on the day he is negligent, he may not have it at the time a client discovers the mistake. Therefore, knowing that a lawyer has malpractice insurance may actually harm the client by giving the wrong impression.

The proponents urge that the statement required by the Model Rule is a minimum, and that state rules may require more explicit disclosure. The proponents also argue that the rule may encourage lawyers to have liability insurance; experience shows that states with mandatory disclosure or coverage requirements have a significantly decreased level of uninsured lawyers.

Opponents further argue that a mandatory disclosure or maintenance rule may be a disadvantage to attorneys who cannot afford insurance and whose legal practices function on a limited budget, or on a part-time basis, or where lawyers choose to be uninsured because they choose their cases and clients specifically to avoid risks that warrant insurance coverage. Mandating (or effectively mandating) insurance coverage could also negatively impact the availability of legal representation to the poor, and making coverage mandatory for client protection frustrates the main purpose of insurance which is to protect the covered lawyer and not the client.

Proponents counter by saying that an insurance disclosure and maintenance system is “lawyers regulating lawyers” even if the insurance industry participates. They argue that although insurance is an added cost, it is just another business expense, and in the grand picture, insurance is cheaper to the profession than clients damaged by attorney malpractice going uncompensated because lawyers had no insurance coverage.

The arguments presented above are not exhaustive, but they do give a good indication of the nature of the discussions for and against mandatory insurance disclosure or maintenance. The MSBA Business Law Section Council encourages you to give the issue consideration. Do you support a Maryland rule requiring lawyers to carry professional liability insurance or to disclose information about their coverage? If so, do you have suggestions on what form a proposed Maryland rule should take? If the Maryland Court of Appeals determines to consider the Model Rule further, you might want to make your voice heard.

INCREASE YOUR INVOLVEMENT AND GET YOUR NAME OUT THERE!!! The following subcommittees of the Section of Business Law are looking for members to serve as Vice-Chair. This is a valuable and rewarding experience for anyone interested in increasing his or her participation in the Section of Business Law. If you are interested, please contact the subcommittee Chairs listed below.

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*Submissions, questions, comments?*

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