Business Law Quarterly—Fourth Quarter 2011

Editor's Column

This issue of Business Law Quarterly includes the first of two articles about Cloud Computing, written by Janet Stiven. Janet is a business transactional and corporate partner in our Chicago office. She is also the moderator of Dykema's Executive Circle, a group of senior executives of some of our clients who meet periodically to hear a speaker on a particular topic of interest and for discussion and exchange of ideas. Please contact Janet if you think you might be interested in participating.

Also, herein is the second of our articles about interest rate swap documents. Due to the complexity of the ISDA documents, we are planning two additional articles in our upcoming issues to complete our discussion of the basics on swaps.

Another article in this issue is about Montana v. Wyoming*, a Supreme Court decision concerning a water rights dispute between those states. Illinois and the other states which border the Great Lakes, and the Provinces of Quebec and Ontario, are signatories to Great-Lakes—St. Lawrence River Basis Water Resources Compact, and the related Great-Lakes—St. Lawrence River Basis Water Resources Agreement, both of which went into effect on December 13, 2005. These agreements establish a framework for the Great Lakes states and provinces to work together to protect, conserve and manage the surface waters and groundwaters of the Great Lakes Basin. In upcoming issues we expect to provide more information about these documents and their effect, so far.*

Recently, I read Charles Fishman's book The Big Thirst, an interesting and sometimes alarming volume about water. It contains a great deal of information. For example, did you know that the United States uses more water each day than it uses oil in a year? Or that our average daily home use is 99 gallons per day per person, which seems like a lot given that we drink less than 1% of that and only use about 35 gallons for a shower or bath. More interesting to me were the stories of Orme, Tennessee, 40 miles west of Chattanooga, which ran out of water during the drought that peaked in 2007, Atlanta, which almost ran out during the same drought, and Galveston, which lost its municipal water supply during Hurricane Ike in September, 2008 and needed almost two weeks to get things running again. These were not the only recent water shortage stories but they made clear how uninhabitable our homes and towns would be without water service, something we generally take for granted. We've had 100 years of safe, cheap and available water in this country and grown to take it for granted. We shouldn't. Our systems are aged and need overhaul. We should think about being more careful with how we use this very precious resource and take steps to be less wasteful, as we make the necessary investments for the future.

Andrew Connor, *Editor*

Cloud Computing: Understanding the Business Benefits and Legal Issues (Part I)

"Cloud computing" is Internet-based computing, where computing services are provided on demand by third parties over a network to multiple customers, typically using shared computing resources, software and services. Although the concept is not new, the wide availability of high-speed Internet connections and a desire to better manage expenses has many businesses now considering how cloud computing might benefit their business operations.

Lower cost, increased scalability and flexibility are among the benefits offered by effective cloud computing solutions. While the economic conditions of the past several years led companies to focus on cloud computing as part of cost containment, companies now are also considering how cloud computing can assist in business growth. This resulted in cloud computing being ranked among the top three priorities for CIOs in 2011.

Cloud computing is a tool that companies use to expand data capacity, reduce costs, and enable accessing applications and data anywhere, anytime, independent of a user's device and location. Since charges are based on usage, cloud computing customers can minimize the capital expenditures needed to purchase, manage, maintain and scale the physical infrastructure required to handle network traffic fluctuations and, instead, simply pay for the resources they use, as they use them. Increasingly, companies are turning to cloud-based services for business functions, such as human resources, CRM and email. Companies are being more cautious, however, about use of the cloud for those systems that contain mission-critical data or intellectual property. Some of the key legal issues for businesses considering cloud computing include privacy and data security, regulatory compliance, service levels, and procedures for transition to a different service.

Cloud Computing Is a Service

The delivery models by which users can access cloud computing on an "as a service" basis over the Internet vary and include infrastructure as a service (IaaS), platform as a service (PaaS) and software as a service (SaaS).

Infrastructure as a Service (IaaS). An IaaS offering is the most basic cloud delivery model and the one that has gained interest among companies looking to leverage value from the cloud. IaaS providers can deliver IT infrastructure assets such as additional computing power and storage space on demand through the cloud. The extensive storage space available in the cloud makes the cloud attractive for business continuity backup and recovery storage.

Examples: Rackspace and Amazon EC2

Platform as a Service (PaaS). In PaaS offerings, the cloud provides a computing platform (with such capabilities as database management, security, workflow management and application serving) on which the user can develop and execute its own applications.

Examples: Office 2.0 and Google Docs

Software as a Service (SaaS). Businesses are probably most familiar with this type of cloud computing, where third parties provide web-based access to software applications, which eliminates the need for users to license, install, run and maintain the applications on their own systems. SaaS service providers can offer complete application suites or selected services.

Examples: Salesforce.com and Gmail

Public and Private Cloud Delivery Options

Cloud computing is offered through a variety of service delivery options:

- *Public clouds.* These are resources provided on a shared, self-service, "pay as you go" basis and are open to the public via the Internet. Public clouds often can deliver the best economies of scale, but their shared infrastructure model can limit customization and may not offer sufficient security for users storing highly sensitive data.
- *Private clouds.* In contrast to public clouds, private clouds offer a dedicated hardware environment, managed by the business or a third party, that is typically restricted to a single enterprise for private internal use. This model offers more modest economies of scale but still can provide some of the scaled resource capabilities and responsiveness of public clouds. Managed private clouds are similar to a hosted IT arrangement.
- *Hybrid clouds.* A combination of public and private clouds, hybrid clouds allow users greater cost savings for functions involving less critical data on a public cloud and to expand private clouds into public clouds to meet peak demand.
- *Community clouds*. A community cloud is shared by several entities. It may be managed by the entities or by a third party and may exist on premises or off premises.

Benefits of Cloud Computing

Among the benefits of cloud computing is the ability to reduce large capital expenses associated with software, hardware and related services and convert these capital expenditures to operating expenses through service agreements with cloud vendors. Cloud computing also provides companies with cost savings by reducing utility costs, labor expenses for IT personnel and costs for additional infrastructure, such as space for equipment, by shifting those expenses to the third-party cloud providers.

Cloud computing provides flexibility and scalability for computing operations. Companies using the cloud buy only what they need and pay as they go. This allows companies to avoid the need to purchase excess capacity to meet peak demand periods but to respond more rapidly and cost-effectively to fluctuations in demand. Cloud computing can lower the risk of new service offerings, since companies do not need to make the infrastructure and software investment.

Considerations Before Contracting for Cloud Services

What do companies need to consider when looking at clouds? Before entering into a cloud service arrangement, it is important for a business to undertake due diligence to ensure that the nature of its business allows for use of cloud services and that the cloud vendor will be able to meet the needs of the business. It is important to ensure that the service provider is reputable and reliable as well as financially stable. Also, prior to signing an agreement with a cloud vendor, a customer should understand its rights to terminate the agreement and to develop a transition plan to move its data.

In evaluating whether cloud services are right for your business, it is important to first understand the business need and how a cloud solution fits into your company's business strategy. A company should clearly identify the business problem and then identify possible solutions, including cloud solutions. It is essential to include members from IT, legal, human resources and various other business units in these discussions, to ensure a comprehensive and effective solution.

In Part II of this article in the next issue of *Business Law Quarterly,* we will discuss what you should consider before entering into a contract for cloud services.

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ISDA and All That (Part II)

In our most recent issue of *Business Law Quarterly* we wrote about interest rate swaps and introduced the ISDA Master Agreement, Schedule and Credit Support Annex. Here we offer some additional guidance with respect to those documents.

In many negotiations, the parties use a term sheet or letter of intent as a way to pin down the major points. With ISDA documents, this is done through negotiating the Schedule, and, if collateral will be involved, Paragraph 13 to the Credit Support Annex. The Schedule modifies the Master Agreement. Paragraph 13 modifies the form Credit Support Annex. Put another way, the Master Agreement and the Credit Support Annex contain the "default" provisions that govern except as otherwise specified in the Schedule and Paragraph 13. So you have to review and become familiar with the Master Agreement and the Credit Support Annex. You also have to think about the following, which are the major questions that have to be resolved before the Schedule and Paragraph 13 can be negotiated and finalized:

1. Are the parties both creditworthy, or will one side (or both) want collateral or a guaranty (a "Credit Support Document" in the ISDA lexicon) from someone creditworthy (a "Credit Support Provider") supporting the other side's obligations?
2. If collateral is contemplated, when will it be required? Normally, a party doesn't want to have to post collateral unless and until a minimum risk threshold is passed. For example, if your counterparty's position on a swap is underwater by $1,000, you might be comfortable with the credit risk. But if the amount were $1 million, you'd be more concerned about being able to collect if the swap is terminated. How big does a party's "Exposure" (ISDA's term for the amount that one party would owe the other if the swap were terminated at that time) have to be before collateral must be posted by that party?
3. Who does the valuation to determine "Exposure"—to decide when collateral must be posted? And how often will "Exposure" be determined? Daily? Weekly?
4. What types of collateral will be "eligible"? To avoid problems, collateral should be easy to value and easy to liquidate, such as Treasury bills or cash.
5. How will collateral be valued? Should it be 100% of current market value? Or should it be valued on some other basis?
6. Who will hold any posted collateral? Simplest is for the party whose position is "in-the-money" to hold any collateral posted by the other party, but one party or the other may prefer to have a custodian for any collateral posted by that party. If a custodian is required, who chooses the custodian and who pays for it?

7. If a party is to directly hold collateral posted by the other, can the party holding it use it? When you deposit cash with a bank, the bank is free to use the cash, including lending it to someone else. Will a party holding collateral have similar rights? Remember that the party holding collateral has a swap transaction that is in-the-money and would be entitled to be paid if the swap were to be terminated, so it is not unreasonable for that party to want to be able to use the collateral if it is approximately the same value as the amount that would be owing.
8. What happens to interest or dividends earned on posted collateral? Do they go to the party posting the collateral or are they kept with the collateral as more collateral?
9. If there is an early termination, who should have the right to do the calculation to determine which party is in the money and what amount that side is entitled to be paid? And how will that amount be determined?
10. What events should allow early termination (in addition to the obvious ones such as breach of the agreement and bankruptcy of a party)? There are many possibilities:

- Cross-default to other debt of a stated minimum amount, or to other agreements or contracts
- Judgment in excess of a stated minimum amount is entered against a party
- Bankruptcy or insolvency of a party
- Loss of key personnel
- Decline in net worth or net assets of at least a stated minimum amount
- Material adverse change in financial condition
- Force majeure
- Changes in applicable tax treatment

Some of these could also apply with respect to a “Credit Support Provider” or another entity deemed to be significant with respect to a party, such as a parent entity, even though it is not providing a guaranty (called a “Specified Entity”).

A number of other matters that are usually less contentious also remain to be agreed upon with respect to the Master Agreement, such as closing deliveries and periodic reporting requirements, both of which are to be specified in Part 3 of the Schedule. Closing deliveries usually include copies of organizational documents and authorizing resolutions of the directors, managers or general partners (as applicable), and a certification of signatures and incumbency of persons authorized to sign documents for that party. Sometimes, a legal opinion is also requested. Periodic reporting typically includes delivery of financial statements, but may also require certain other information, such as monthly net worth.

The Schedule also requires addresses for notices, provides for, on a kind of “check-the-box basis”, tax and other representations for consideration, and includes certain other provisions that the parties need to consider and either complete or delete, such as venue in New York City for disputes.

In the next issue of Business Law Quarterly we’ll discuss Events of Default and Termination Events.

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Who is Monitoring the Baby Monitor?

A recent case from Illinois involved claims of deceptive business practices and breach of implied warranty of merchantability. In *Jamison v. Summer Infant (USA), Inc.,*[1] parents using video baby monitors were surprised to find out that neighbors could have been watching their children as a result of the unencrypted signals and brought complaints against the manufacturer of the monitors and the retailer selling such units.

Baby monitors are used by parents and caregivers to monitor sounds and, more recently, video transmissions from a child’s room. Consumers purchase these monitors as a safety and convenience measure to monitor children from different rooms. The products at issue in this case were manufactured by Summer Infant (USA), Inc., and sold by Toys “R” Us d/b/a Babies “R” Us. These baby monitors had two components. The base unit was located in the child’s room and contained a microphone and a camera. The receiving unit received the audio and/or video transmitted by the base unit. Video monitors use public airwaves to transmit their signals, and therefore those signals can be picked up by other receivers within the transmission area. Some manufacturers therefore use encrypted signals. But the ones in this case did not, and their signals could be viewed by anyone with a receiver on the same channel. Alissa Jamison, the named plaintiff, placed the base units of two of these video monitors in her children's rooms, kept them on at all times, and entered her children's rooms at all hours of the day and night, in various states of dress. At times she breastfed her children in the rooms that contained the base units. One day, Jamison saw a neighbor from across the street on one of her receiving units. The other named plaintiff, Mandy Brantley, had an experience similar to Jamison's. One of her neighbors informed her that he could see her on his video monitor. Jamison and Brantley indicated that they were shocked to learn of the transmission capabilities of the monitors and would not have purchased the monitors if they had known that the signals were not private and that the monitors would broadcast images from inside of their homes readily viewable to others outside.

Jamison and Brantley, in a class action for themselves and others similarly situated, sued Summer Infant and Babies "R" Us based upon (i) alleged violation of the Illinois consumer Fraud and Deceptive Business Practices Act (ICFA) by omitting in the advertising and warnings on the packaging boxes the material fact that the monitors broadcast unencrypted signals, (ii) alleged violations of the Magnuson-Moss Warranty Act by breaching the implied warranty of merchantability under Illinois and other states' laws by selling products that cannot be used securely for their ordinary purpose, (iii) unjust enrichment, and (iv) negligence in the manufacturing, distribution and sale of the monitors and failing to give adequate warnings that the monitors could broadcast an unencrypted signal.

The defendants moved to dismiss. The court's ruling on that motion began with analyzing provisions of the ICFA and the Magnuson-Moss Warranty Act. The Illinois Consumer Fraud and Deceptive Business Practices Act makes it unlawful to use deception or fraud in the conduct of trade or commerce. Under the ICFA, a plaintiff must allege (i) a deceptive act or practice by the defendant, (ii) the defendant's intent that the plaintiff rely on such deception, (iii) the occurrence of the deception in the course of conduct involving trade or commerce, and (iv) actual damage to the plaintiff proximately caused by the deception. Among other arguments, the defendants tried to get this count dismissed on the ground that the consumer fraud claim under the ICFA was preempted by FCC regulations, claiming that the ICFA exempted the defendants' labeling practices because they complied with the FCC's labeling regulations.

The court said that federal law can preempt state laws in any of three ways: (i) when a state law is expressly preempted by Congress, (ii) when a state law regulates conduct in a field where Congress has enacted law that intends that the federal government occupy the field exclusively, or (iii) when a state law actually conflicts with federal law. Here, the defendants argued that there was preemption due to actual conflict because allowing the plaintiffs' ICFA claim to proceed would frustrate Congress' objective enacting the Federal Communications Act and creating the FCC in order to prescribe technical standards and operations rules applicable to broadcasting without regard to state boundaries.

The court did not find any merit in this argument—finding that compliance with the FCC regulations was a requirement to enter the broadcast equipment market but not a shield from operating in the marketplace. Therefore, defendants' compliance with the technical labeling requirements of the FCC did not protect them from allegations that their marketing and advertising practices were unfair or deceptive.

The defendants also argued that the ICFA exempted the defendants' practices because a portion of the ICFA provides that nothing in the ICFA shall apply to any actions or transactions that are specifically authorized by laws administered by the United States government. However, this argument was rejected by the court because the FCC's technical labeling requirements do not preclude regulation relating to the marketing or advertisement of the monitors.

The defendants also argued that the plaintiffs' claims for alleged violations of the ICFA should be dismissed because the plaintiff failed to allege that the monitors had any defect or that the plaintiffs had suffered any damages. The court did not find these arguments persuasive, because there is no requirement under the ICFA to plead a claim of malfunction to state a claim of deception. With respect to damages, the plaintiffs' assertions that they would not have purchased the monitors if the fact that the signals were unencrypted had been disclosed on the packaging and in the advertising was sufficient to show harm in the form of payment of the purchase price for the products and that met the actual damages pleading requirement.

The court then turned to the alleged violations of the Magnuson-Moss Warranty Act, which permits a suit for breach of an implied warranty arising under state law. Plaintiffs claimed that the defendants had breach the implied warrant of merchantability under Illinois law by selling products that could not be used securely for their ordinary purpose. To allege a breach of implied warranty of merchantability under Illinois law, a plaintiff must plead a sale by a merchant of goods that were not of merchantable quality. To be merchantable, goods must pass without objection in the trade under the contract description, be fit for the ordinary purposes for which such goods are used, and conform to the promises or affirmations of fact made on the container or label. On this issue, the court dismissed the Magnuson-Moss claim against Summer Infant because there was no privity between the plaintiff and Summer Infant, since Summer Infant was not the "immediate seller" of the monitors and therefore not the merchant of the goods for purposes of the Magnuson-Moss Warranty Act. But the claim against Babies "R" Us was allowed to proceed. Plaintiffs had alleged that the ordinary purpose of the monitors was to allow secure monitoring of their infants and not by others outside of the home. Defendants argued that the ordinary purpose of the monitors was merely "for video and audio to be transmitted over a three channel selection over a 350-foot range." The court found that plaintiffs had pleaded sufficient allegations on the point to raise questions that could not be decided on a motion to dismiss.

The defendants also moved to have plaintiffs' claim for unjust enrichment dismissed. However, based upon the alleged violations of the ICFA and for breach of implied warranty under the Magnuson-Moss Warranty Act, the court decided that the complaint sufficiently alleged a claim for unjust enrichment, because, to state a cause of action for unjust enrichment under Illinois law, a plaintiff must allege that the defendant has retained a benefit to the detriment of the plaintiff and that such retention violates fundamental principles of justice, equity and good conscience.

The defendants had two primary arguments regarding plaintiffs' claim for negligence. First was the argument that the defendants didn't owe any duty to the plaintiffs. To state a claim for negligence in Illinois, a plaintiff must allege the existence of a duty owed by the defendant to the plaintiff, a breach of such duty and an injury proximately resulting from the breach. In addition, a plaintiff cannot sue in negligence to recover a purely economic loss. There must be a claim of personal injury or damage to property. Defendant's argument on the issue of duty was that they had no legal duty to disclose that the monitors used public airwaves to transmit unencrypted signals and that plaintiffs were seeking only economic damages. The court rejected this, finding that there could be a duty to disclose such facts and that the plaintiffs' requests for relief included damages for emotional distress suffered when they learned that they and their families had been watched within their homes without their knowledge and consent and in a place where they had the right to expect privacy. Claims for emotional distress are not claims for economic damages.

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Montana Water Claim Denied

When two states have a dispute, the United States Supreme Court has original jurisdiction, meaning that it serves as the trial court for the case – one of the few instances in which the Supreme Court fills such a role. In May, 2011, pursuant to such authority, the Supreme Court issued a decision in *Montana v. Wyoming*, 131 S. Ct. 1765, a water rights dispute between the States of Montana, Wyoming and North Dakota. The case involved Article V(A) of the Yellowstone River Compact, an agreement among Wyoming, Montana and North Dakota concerning rights to water in the Yellowstone River Basin drainage system. Article V(A) of the Compact provides that prior appropriative rights to the beneficial uses of the water of the Yellowstone River System existing as of January 1, 1950 will continue to be "enjoyed in accordance with the laws governing the acquisition and use of water under the doctrine of appropriation".

The doctrine of prior appropriation provides that rights for water from a particular source, such as a river, are governed by seniority, starting with the first person to divert water from the source and apply it to a beneficial use. If the water source is surface water, such as a pond or stream, it is not necessary for the user to actually own any land that abuts the water. This contrasts with "riparian" water rights. The doctrine of prior appropriation is the law in most of the western United States. Once a user has "perfected" his right by diverting water for a beneficial use, he may continue to do so and his right to water is senior to later appropriators' rights and is entitled to be fulfilled entirely before the junior appropriators get any water, although junior users do have the right to prevent the senior user from enlarging his rights.

In the case, Montana claimed that Wyoming had breached the Compact by consuming more than its share of the Tongue and Powder Rivers (tributaries to the Yellowstone) through several uses, one of which was that Wyoming farmers using irrigation had switched to sprinkler systems (instead of flood irrigation) which resulted in crops absorbing more of the water with the result of less return flow to the rivers. This reduction in return flow resulting from "irrigation efficiency improvements", said Montana, was depriving Montana's junior users in violation of their rights.

The Supreme Court referred the dispute to a Special Master, something which it often does in cases where it is called upon to act as trial court. After briefing, the Special Master upheld some of Montana's claims but denied the irrigation efficiency improvements claim. Montana objected to this part of the Special Master's Report, even though Wyoming's users were not actually taking any more water from the rivers, nor were they irrigating more land. The basis of Montana's objection was that the change from flood irrigation to sprinklers was resulting in considerably less water was running off back into the rivers. Justice Thomas, writing for the court, framed the issue this way: "The question, therefore, is whether Article V(A) allows Wyoming's pre-1950 water users—diverting the same quantity of water for the same irrigation purpose and acreage as before 1950—to increase their consumption of water by improving their irrigation systems even if it reduces the flow of water to Montana's pre-1950 users."

Justice Thomas, writing for the court, framed the issue this way: The question, therefore, is whether Article V(A) allows Wyoming's pre-1950 water users—diverting the same quantity of water for the same irrigation purpose and acreage as before 1950—to increase their consumption of water by improving their irrigation systems even if it reduces the flow of water to Montana's pre-1950 users."

The court reviewed various cases and authorities, acknowledging that the law with respect to recapture of runoff was far from clear, but concluded that the overall principles of the prior appropriation doctrine supported the right of the user to change to irrigations methods that increase the amount of water kept by the user's use. The Court cited certain Wyoming caselaw holding that the lower appropriators are "at the mercy of the property owners from which their water flows." Justice Thomas also relied on a statement in a water law treatise as authority for the principle that under the prior appropriation doctrine a senior user could switch to a more water-intensive crop so long as he makes no change in acreage irrigated or amount of water diverted.

Montana made a second, more technical, argument based on the Compact's definition of "beneficial use", claiming that the Compact restricted the scope of the pre-1950 protected rights to the net volume of water that was actually being consumed in 1950. The term "beneficial use" was defined as "that use by which the water supply of a drainage basin is depleted when usefully employed by the activities of man." According to Montana, any activity that increased the pre-1950 users' depletion over the 1950 levels exceeded the scope of appropriative rights that were protected. But the Court was not convinced and ruled that the cited wording merely referred to the type of use causing depletion—not to measuring the amount of water depleted. If the Compact were intended to guarantee to Montana a set quantity of water, it could have done so in plain language, but it did not. Accordingly, the Special Master's conclusion that the Wyoming irrigation efficiency users were not in violation of the Compact was upheld.

Justice Scalia filed a dissenting opinion, specifically taking issue with the court's construction of the word depletion as used in the Compact's definition of beneficial use. He emphasized that "the Compact's authors chose to define beneficial use in terms of depletion—the first and only time the Compact uses any derivative of the word deplete. It is in my view a clear indication that the Compact intends to break from the common law's focus on diversion." Thus, said Justice Scalia, the focus is on whether the use depletes the water supply beyond the level prior to 1950, which clearly the Wyoming uses did, not on whether there was an increase in the diversion of water. The argument that the Compact could have guaranteed a set amount but didn't Scalia called a straw man. Montana wasn't asking that it always receive enough water to satisfy the pre-1950 Montana users' needs. It was only claiming that whatever would have flowed back into the rivers after the Wyoming appropriators' beneficial uses as in effect in 1950 be allowed to continue to flow back. In dry years, Montanans still might get less or no water. Alas for Montana, Scalia's view did not prevail.

The doctrine of prior appropriation is not the law in Illinois. Instead, Illinois recognizes "riparian" rights, as do other eastern states, although just what that means is subject to some variation among jurisdictions. Under riparian water doctrine a key requirement is that the land must touch the body of water in order for the land holder to have the right to use the water. And the land holder has rights that extend out into the water, such as the right to construct a boat dock. Historically, the holder of the riparian right had the right to use any amount of the water, provided that such use did not hinder the natural course of flow or existence of the body of water and thereby affect other riparian owners' rights. Over time, this principle has been adapted to what courts have called a right to "reasonable" use of the water. So the riparian owner is not assured of an unlimited use of water, or even a set amount of water, because a use is not reasonable if it interferes with the use of the same source of water by other holders of riparian rights. Similarly, the owner cannot build a dock that interferes with his neighbor's access to the water (including his neighbor's right to build a reasonable dock). If there is not enough water for the various competing uses of the riparian rights holders, then the available water is subject to allocation among them, unlike under the prior appropriation doctrine where the senior user comes first. If the parties can't agree on allocation, it will be decided through litigation, unless the state has established an agency or tribunal for such purpose. In addition, riparian rights are appurtenant to the land and cannot be transferred separately, which is not the case with the prior appropriation rights, which are unconnected with land ownership and can be sold or mortgaged independently.

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More "Reliable" Noncompete Agreements

Illinois employers may have an easier time enforcing noncompete agreements after a recent decision by the state's highest court.

In *Reliable Fire Equipment Company v. Arredondo*, the Illinois Supreme Court rejected the state's existing legal tests for the reasonableness of noncompetition restraints. Instead of focusing on a few discrete factors as the exclusive gauges of what is reasonable, state courts are now instructed to consider all the circumstances surrounding a noncompete agreement, including a general inquiry into the underlying business interests of the employer, whatever they may be.

The Reliable case stemmed from a dispute between Reliable Fire Equipment Company (RFEC), which sells fire alarms and extinguishers, and two of its salesmen who started their own similar business while still employed by RFEC. The individual defendants, Arnold Arredondo and Rene Garcia, had signed noncompetition agreements prohibiting them from competing with RFEC in Illinois, Indiana or Wisconsin for one year after their termination of employment; from soliciting sales or referrals from RFEC customers and referral sources; and from poaching RFEC employees.

In 2004, while working for RFEC, Arredondo and Garcia formed High Rise Security Systems, LLC, which had a stated purpose of selling fire alarm systems in Chicago. Shortly after Arredondo resigned from RFEC and Garcia was fired on suspicion of competition, RFEC sued them and their new company for competing with RFEC, soliciting referrals from RFEC's referral sources and soliciting a number of RFEC employees to join the new company.

In a bench trial in 2007, the lower court rejected RFEC's claims and called its noncompete restrictions unenforceable against the defendants, because RFEC had failed to show a legitimate business interest that would justify enforcement. The ruling was affirmed on appeal. But in its unanimous decision on December 1, 2011, the Illinois Supreme Court reversed both lower courts, taking the opportunity to correct what it called "erroneous" lower court case law on the enforceability of noncompetition agreements.

Under Illinois law (before and after the Reliable decision), a noncompetition agreement is enforceable against the subject employee if (a) the employment restrictions in the agreement are reasonable, and (b) the employee receives consideration (e. g., employment) in exchange for agreeing to those restrictions. Where the Reliable court sought to set the record straight was in clarifying the proper test for reasonableness among the various formulations that had arisen in Illinois.

According to the court, the appropriate test for whether noncompetition restraints are reasonable is, and always should have been, what the court calls "a three-prong rule of reason." Prong 1 requires that the employment restrictions be no greater than necessary to protect a legitimate business interest of the employer. Prongs 2 and 3 prohibit the restrictions from imposing an undue hardship on the employee or an injury on the public.

As to the first prong, the Reliable opinion instructs courts to consider all potentially legitimate business interests raised by an employer and to consider how, based on the totality of the circumstances, the particular noncompete's restrictions serve those interests. Factors to be analyzed could include (a) the near permanence of the employer's customer relationships, (b) the employee's acquisition of the employer's confidential information, and (c) the scope of the restrictions in duration, location and types of prohibited activity.

Where lower courts have gone astray, according to Reliable, is in failing to see the forest (of reasonableness) for the trees (of particular circumstances). Instead of considering all the business reasons behind an employment restriction, Illinois courts have come to focus solely on a few particular issues as the test for the reasonableness of noncompetition agreements.

The Reliable court rejected two such approaches, the first of which had dispensed with any inquiry into the business interests served by the covenant not to compete. Instead, that test had called for courts to consider only the time and territory restrictions of the noncompete and whether a public harm or undue hardship on the employee would result. This approach, established in the 2009 case *Sunbelt Rentals, Inc. v. Ehlers*[1], denied that an employer's interests are part of the reasonableness equation. The Illinois Supreme Court "emphatically" disagreed, stating that "[e]ven a cursory review" of Illinois precedent shows that an employer's business interests must be considered in assessing the reasonableness of a covenant not to compete.

In the second case, *Nationwide Advertising Service, Inc. v. Kolar*[2], a state appellate court had held that there are only two possible business interests that may legitimately support a covenant not to compete: (i) protecting the employer's near-permanent relationships with customers that the employee would not know but for his employment, and (ii) protecting the employer's confidential information to which the employee would not have access but for his employment. As the Illinois Supreme Court said in Reliable, this approach had become the sine qua non for the enforcement of noncompetition agreements during more than thirty years of "erroneous proliferation" of the test in Illinois case law. The Reliable court invalidated the fixed formula from Kolar as unduly restricting the field of potentially legitimate business interests that could be served by covenants not to compete. The court's preference is for a more flexible analysis. Litigants will look for guidance to the "several factors and subfactors" that have been recognized by the common law as relevant to what is or isn't a legitimate business interest. However, such factors are merely "nonconclusive aids in determining the [employer's] legitimate business interest, which in turn is but one component in the three-prong rule of reason, grounded in the totality of the circumstances." No factor has more predetermined weight than any other in the court's newly articulated, fact-intensive test for reasonableness.

We think the court's rejection of the Sunbelt approach is sensible, insofar as it reaffirms that time and territory restrictions are not the only factors to be considered and don't exist in a business interest-free vacuum. Likewise, rejection of the narrow Kolar test gives recognition that an employer's legitimate business interests can encompass more than just protecting customer relations and confidential information. By establishing (or, as the court put it, restoring) a flexible, multifactor, three-pronged "rule of reason," the Reliable court has broadened the inquiry into the reasonableness of covenants not to compete. As always, it must be shown that no public injury or private undue hardship will result from enforcing a noncompete. But Reliable affirms that an employer can also defend its noncompetition agreements by pointing to the legitimate business interests served thereby (contra Sunbelt). And (contra Kolar) the universe of potentially legitimate business interests is no longer limited to protecting confidential information and near-permanent customer relationships.

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For more information about any of the material contained in the Business Law Quarterly, please contact the author or the editor or one of the Dykema attorneys with whom you work.

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[1]Based upon 2011 CIO Agenda survey by Gartner Executive Programs.
[2]344 Ill. App. 3d 421 (2009).
[3]28 Ill. App. 3d 671 (1975).

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