72314-6

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No. 11-2-03210-6 (trial court)
No. 72314-6 (Court of Appeals)

COURT OF APPEALS DIVISION I
OF THE STATE OF WASHINGTON

Michael Salewski, D.V.M., an individual,
Appellant

v.

Pilchuck Veterinary Hospital, Inc., P.S., a Washington corporation,
Respondent

BRIEF OF APPELLANT

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INTRODUCTION

This appeal arises from an Order of Snohomish County Superior Court Judge Richard T. Okrent confirming an arbitration award and denying Appellant Dr. Michael Salewski's ("Salewski") Motion to Vacate the award in favor of Respondent Pilchuck Veterinary Hospital, Inc., P.S. ("Pilchuck") on July 14, 2014.

Dr. Salewski is a veterinarian specializing in alternative medicines, in particular chiropractic, acupuncture and Chinese herbal medicines. He became an employee of Pilchuck in 1992. Sometime between 1998 and 2000, Dr. Salewski became a shareholder in the practice. In 2008, Dr. Salewski left the ownership group, remaining on as an employee from 2008 through 2010, when he left Pilchuck and moved to Oregon to begin his own practice there.

At issue in this appeal is the enforceability of a noncompetition provision in a contract signed by the parties in January of 2007 (the "January 2007 Agreement"), as well as a liquidated damages provision also included in that agreement.

To prevail in this appeal, Appellant must demonstrate that the Arbitrator exceeded his powers and that the Trial Court erred in refusing to vacate the arbitration award based on clear error that appears on the

face of the award. This includes any issues of law evident in the face of the award.

In this case, the Trial Court erred in refusing to vacate the arbitration award based on two fundamental legal errors found on the face of the award. First, the arbitrator, and then the Trial Court, concluded that the noncompetition provision signed in the January 2007 agreement was enforceable and supported by adequate consideration, even though Dr. Salewski ceased being a shareholder in 2008 and returned to his status as an employee. In reaching this conclusion, the arbitrator and the Trial Court misconstrued the holding of the Washington Supreme Court in *Labriola v. Pollard Group, Inc.*, 152 Wn.2d 828, 834, 100 P.3d 791(2004), requiring that independent, additional consideration is required for the valid formation of a modification or subsequent agreement of a noncompetition agreement.

In addition, the arbitrator, and the Trial Court, upheld the existence of a liquidated damages clause in the January 2007 agreement, despite the fact that the liquidated damages clause constituted an unenforceable penalty. In this case, the specific noncompetition restriction prohibited Salewski from practicing veterinary medicine anywhere within a 50-mile radius of Pilchuck's office for a three-year period. The noncompetition provision further prohibited Salewski from performing veterinary services

outside the 50-mile radius for any clients who had been served at one time by Pilchuck.

The liquidated damages clause in the January 2007 agreement provided for damages in the amount of $300,000 for any violation of this extremely broad covenant. Rather than serving as a reasonable forecast of just compensation for the potential harm caused by the breach, an award of $300,000 for any single violation is exactly the kind of damages award that is punitive in nature and a classic example of money stipulated *in terrorem* of the offending party.

For these reasons, Appellant respectfully submits that the arbitration award is clearly erroneous on its face and that the Trial Court erred in refusing to vacate the arbitration award.

ASSIGNMENTS OF ERROR

I. Assignment of Error No. 1

The Trial Court erred in confirming the arbitration award in favor of Respondent and denying Appellant's Motion to Vacate the award on July 14, 2014.

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II. Assignment of Error No. 2

The Trial Court erred in refusing to vacate the arbitration award as erroneous on its face on the ground that the noncompetition provision at issue was not supported by adequate consideration.

III. Assignment of Error No. 3

The Trial Court erred in refusing to vacate the arbitration award as erroneous on its face on the grounds that the liquidated damages clause in the amount of $300,000 for any violation of the covenant was an unenforceable penalty.

ISSUES PERTAINING TO ASSIGNMENTS OF ERROR

I. Issue - Assignment of Error Nos. 1 and 2

Was there adequate consideration to support the enforcement of the noncompetition agreement that formed the basis for the Arbitration Award?

II. Issue - Assignment of Error Nos. 1 and 2

Can the promises of other shareholders in their own separate employment agreements provide consideration for a subsequent noncompetition agreement by another shareholder?

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III. Issue - Assignment of Error Nos. 1 and 2

Does continued employment, in and of itself, serve as adequate consideration for a noncompetition agreement entered into after initial employment?

IV. Issue - Assignment of Error No. 1 and 3

Is a liquidated damages clause that provides for $300,000 in damages for any single violation of a noncompetition provision enforceable or an unenforceable penalty?

STATEMENT OF THE CASE

I. Procedural Background

1. Appellant Michael Salewski, D.V.M. brought the instant action against defendant, Pilchuck Veterinary Hospital, Inc., for breach of contract based on Pilchuck's failure to pay on a promissory note issued to Dr. Salewski as part of the buyout of his interest in the company. CP 387-390.

2. In response, Pilchuck counterclaimed, alleging Dr. Salewski entered into a noncompetition agreement in January of 2007 which he later violated. CP 379-386.

3. Dr. Salewski moved for summary judgment on the promissory note and Pilchuck filed its own cross-motion for summary judgment on its claim Dr. Salewski breached the noncompetition agreement. CP 353-370; CP 271-295.

4. On June 12, 2012, the Honorable Linda C. Krese granted Dr. Salewski's motion for summary judgment on the promissory note and denied Pilchuck's cross-motion, leaving the only dispute in this case the validity of the noncompetition agreement and its corresponding liquidated damages provision. CP 151-153.

5. On the agreement of the parties, the remaining counterclaim was submitted to an arbitrator on October 22, 2013. CP 146.

6. On November 7, 2013, Salewski received notice of the arbitrator's tentative award in favor of Pilchuck. CP 146-150.

7. Appellant timely motioned the arbitrator on November 13, 2013 to change the award based on errors of law and fact in the arbitrator's tentative opinion pursuant to RCW 7.04A.200. CP 143-145.

8. On February 26, 2014, Dr. Salewski received notice that the arbitrator denied his motion to change the award, and received a copy of the final arbitration award. CP 143-145; CP 146-150.

9. Dr. Salewski timely filed a Motion to Vacate the Arbitration Award pursuant to RCW 7.04A.230, along with a Memorandum in Support of this Motion. CP 114-115; CP 85-113.

10. Appellant also filed a timely opposition to Pilchuck's motion to confirm the Arbitration Award in Snohomish County Circuit Court, opposing the entry of the Arbitration Award. CP 10-14.

11. On June 12, 2014, the Snohomish County Superior Court, the Honorable Richard T. Okrent, heard argument on Appellant's Motion

to Vacate and Respondent's Motion to Confirm the Arbitration Award. CP 15-27.

12. Ultimately, the Trial Court denied Appellant's Motion to Vacate the Award. The Order denying this motion and confirming the Arbitration Award was entered on July 14, 2014. CP 10-14.

13. Appellant timely appealed from this Order of Court, filing his Notice of Appeal on August 7, 2014. CP 2-9.

II. Factual Background[1]

1. Dr. Salewski is a veterinarian specializing in alternative medicines, in particular chiropractic, acupuncture and Chinese herbal medicines. CP 147. He became an employee of Pilchuck on December 17, 1992. CP 146.

2. On that day, Pilchuck , as "Employer", and Salewski each signed an Employment Agreement and an agreement not to compete in which Salewski agreed not to compete with Employer and to "not perform veterinary services of any kind for client served by" Pilchuck "that reside outside of the above stated areas for a period of three years." CP 146.

3. The 1992 agreement provided for liquidated damages of $3,500 per month for each month of breach. CP 146.

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[1] All facts referenced in Appellant's factual background are taken directly from the Arbitrator's Findings of Fact in the Arbitration Award and the transcript of the proceedings before the Trial Court. *See* CP 146-150; CP 15-27. For the purposes of this appeal, Appellant does not take issue with these factual findings, but merely recites certain limited facts from the Award for the purpose of revealing the legal issues on the face of the Award which Appellant contends are clearly erroneous.

4. Salewski and Pilchuck signed an Employment Agreement dated February 13, 1998, which contained an agreement not to compete with a 25-mile radius for three years, and stated that Salewski would not "provide services to any client served by Pilchuck Veterinary Hospital at the time of termination, regardless of where the services are rendered for a period of three years." CP 146.

5. The 1998 agreement provided for liquidated damages in the amount of $3,500 per month. CP 146.

6. Salewski became a shareholder in Pilchuck, buying into the practice and into the property upon which it operated, sometime between 1998 and 2000. CP 147.

7. Each time a new owner was brought in as a shareholder, a new set of documents, including an agreement not to compete, were signed by the shareholders. CP 147.

8. In January of 2007, (the agreement at issue in this case), seven shareholders, including Salewski, signed employment agreements. CP 147.

9. The terms of the agreements changed over time. The November 2002 and March 2005 agreements provided for a 3-year noncompete over a 50-mile radius with a $200,000 liquidated damages clause. CP 147.

10. The January 2007 agreement increased the liquidated damages to $300,000. CP 147.

11. Specifically, the January 2007 agreement provided that, "[a]dditionally, Employee agrees to pay liquidated damages in the amount of Three Hundred Thousand Dollars ($300,000) for any violation of the covenant not to compete." CP 150.

12. In 2008, Salewski indicated that he wanted to leave the ownership group. CP 147.

13. As part of leaving the ownership group and again becoming an employee of Pilchuck, a stock redemption agreement was executed by Plaintiff and the remaining shareholders. CP 147.

14. This Stock Redemption Agreement entered into in 2008 when Salewski became an employee again did not contain a noncompetition agreement. Instead, a paragraph in the agreement merely referenced the noncompetition agreement between Salewski and Pilchuck executed on January 1, 2007 and stated that it would remain in effect. CP 147.

15. In December of 2010, after approximately two years working as an employee for Pilchuck, Salewski moved to Oregon and set up a practice there. CP 147.

16. The Arbitrator found that Salewski violated the noncompetition agreement by providing veterinary services within 50 miles of Pilchuck and also by performing veterinary services outside of the 50-mile radius for clients who had been served by defendant. CP 147.

SUMMARY OF THE ARGUMENT

In this case, the Trial Court erred in refusing to vacate the arbitration award on the ground that the noncompetition agreement at issue was not supported by adequate consideration. In the end, both the arbitrator and the Trial Court misconstrued the requirement under Washington law that a subsequent modification to noncompetition agreement must be supported by additional, independent consideration. *Labriola v. Pollard Group, Inc.*, 152 Wn.2d 828, 836-838, 100 P.3d 791(2004).

Not only did the arbitrator ignore Washington law by relying on earlier noncompetition agreements to find consideration for the current noncompetition agreement, the arbitrator also did not account for the fact Salewski's employment status changed when he left the ownership group and became an employee of Pilchuck in 2008, an event which also required additional, independent consideration for the noncompetition agreement to be enforceable at this time. Instead, the arbitrator incorrectly concluded that the "promises" of other Pilchuck shareholders in their own

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previous employment agreements served as sufficient consideration for both Salewski's January 2007 Agreement and the noncompetition covenant merely referenced in the 2008 Stock Purchase Agreement. CP 148.

The Trial Court further erred in refusing to vacate the arbitrator's award based on clear error on its face, reasoning that under *Labriola*, Salewski's continued employment with Pilchuck, in itself, served as sufficient consideration for the noncompetition agreement. CP 24.

The Trial Court also should have vacated the arbitration award based on clear legal error on the face of the award on the ground that the liquidated damages clause in the January 2007 agreement, which provided for $300,000 in liquidated damages for any, single violation of the noncompetition provision, constituted an unenforceable penalty.

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ARGUMENT

I. The Trial Court erred in denying Appellant's Motion to Vacate the Arbitration Award.

A. Legal Standard

In reviewing an arbitrator's decision, the Trial Court considers whether any of the statutory grounds for vacation exist. *Cummings v. Budget Tank Removal & Envtl. Serv. LLC*, 163 Wn. App. 379, 388, 260 P.3d 220 (2011). One of the statutory grounds for vacating an award is when the arbitrator has "exceeded the arbitrator's powers." RCW 7.04A.230(d); *Cummings*, 163 Wn. App. at 388.

To vacate an award on this ground, the error must appear "on the face of the award." *Federated Servs. Ins. Co. v. Pers. Representative of Estate of Norberg*, 101 Wn. App. 119, 123, 4 P.3d 844 (2000) ("The error should be recognizable from the language of the award, as, for instance, where the arbitrator identifies a portion of the award as punitive damages in a jurisdiction that does not allow punitive damages.").

"Where a final award sets forth the arbitrator's reasoning along with the actual dollar amounts awarded, *any issue of law evident in the reasoning may also be considered as part of the face of the award.*" *Cummings*, 163 Wn. App. at 389 (emphasis added).

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II. The Noncompetition Agreement Lacked Consideration as a Matter of Law.

A. Washington law requires that a subsequent modification to a noncompetition agreement be supported by additional, independent consideration.

As an initial matter, the arbitrator correctly noted in his analysis that adequate consideration is a threshold issue when it comes to the validity of a noncompetition agreement. CP 148. The general rule in Washington is that consideration exists if the employee enters into a noncompetition when he or she is first hired. *Wood v. May*, 73 Wn.2d 307, 310-11, 438 P.2d 587 (1968); *Racine v. Bender*, 141 Wash. 606, 609, 252 P.115 (1927); *Knight, Vale & Gregory v. McDaniel*, 37 Wn. App. 366, 368, 680 P.2d 448 (1984).

That said, Washington Courts are equally clear that a noncompetition agreement entered into after employment will be enforced only if it is supported by separate, independent consideration. *See e.g.*, *Labriola v. Pollard Group, Inc.*, 152 Wn.2d 828, 836-838, 100 P.3d 791(2004) ; *Rosellini v. Banchero*, 83 Wn.2d 268, 273, 517 P.2d 955 (1974); *Schneller v. Hayes*, 176 Wash. 115, 118, 28 P.2d 273 (1934).

In cases where a noncompetition agreement is entered into after employment, the Washington Supreme Court has explained that "[i]ndependent, additional consideration is required for the valid formation

of a ***modification or subsequent agreement***" of a noncompete. *Labriola*, 152 Wn.2d at 834 (emphasis added).

Moreover, there is no consideration when "one party is to perform some additional obligation while the other party is simply to perform that which he promised in the original contract." *Banchero*, 83 Wn.2d at 273 (citing 15 Walter H.E. Jaeger, Williston on Contracts § 1826 at 487 (3d ed.1972)). Independent consideration may include increased wages, a promotion, a bonus, a fixed term of employment, or perhaps access to protected information. *Schneller*, 176 Wash. at 118-19.

In *Schneller*, the Washington Supreme Court held that a noncompete agreement an employee signed just after starting work lacked consideration because the employer failed to advise the employee of the noncompete agreement at the time of the offer for hire. *Schneller*, 176 Wash. at 118, 28 P.2d 273. The Supreme Court reasoned there was no consideration since the noncompete agreement made no promises to the employee for future employment and stipulated nothing as to wages. *Id.*

In *Labriola*, the Court held that consideration was absent in a noncompetition agreement where the employer promised nothing in the way of future employment and nothing was stipulated as to wages. *Labriola*, 152 Wn.2d at 838, 100 P3d 791. Further, during deposition in the case, the employer's president conceded that "no extra benefits or

consideration or promises [were] made to [Employee] if he signed the noncompete." *Id.* While the employer attempted to argue that the employee's continued employment served as consideration for the noncompete agreement, the Court rejected that contention and concluded that consideration was lacking. *Id.*

The concurring opinion in *Labriola,* authored by Justice Madsen, also provided additional guidance. There, Justice Madsen clarified that under Washington law, "[c]ontinued at-will employment, without more, is never sufficient consideration for a noncompete agreement formed subsequent to employment." *Labriola*, at 844 (Madsen, J., concurring) Moreover, Justice Madsen reiterated that "[t]he general rule in Washington is that consideration exists [only] if the [e]mployee enters into a noncompete agreement when he or she is first hired." *Id.*

B. The arbitrator erred as a matter of law in concluding that previously executed noncompetition agreements provided consideration for the January 2007 noncompetition agreement.

In this case, the arbitrator found that there was consideration for the noncompetition covenant in the January 2007 Agreement, appearing to rely on the promises made by other shareholders in the Pilchuck practice (none of whom were parties to the actual January 2007 Agreement with

Dr. Salewski) made in previous years. CP 148. This decision was clearly erroneous and misconstrues Washington law.

> The arbitration award provides, in pertinent part:
>
> Plaintiff and Defendant did enter into a non-compete agreement when he was first hired on December 17, 1992[.]
>
> Plaintiff argues as if the agreement signed in January 1, 2007 was the first non-compete agreement that he signed. It was not. The first one was signed the day he began employment in 1992. This current one was the last of three or four such agreements executed by all of the shareholders of Defendant, of which Plaintiff was one. The promises of the other shareholders were consideration for Plaintiff's promise. Thus there was a bargained for exchange of promises. *Williams Fruit Co. v. Hanover Ins. Co.*, 3 Wn.App. 276, 281.

CP 148.

In finding consideration for the January 1, 2007 noncompetition covenant, the arbitrator appears to misconstrue the holding of the Washington Supreme Court in *Labriola*. Rather than analyze the January 2007 Agreement based on the clear dictates of the Court in *Labriola* (providing that "[i]ndependent, additional, consideration is required for the valid formation of a modification or subsequent agreement.")(*Labriola*, 152 Wn.2d at 836-838), the arbitrator appears to have relied on the language in *Labriola* that discusses the rule that applies to noncompetition agreements entered into when an employment relationship begins. *See Labriola*, 152 Wn.2d at 836-38 ("The general rule in Washington is that

consideration exists if the Employee enters into a noncompete agreement when he or she is first hired.").

But this reasoning is fatally flawed. *Labriola* does not stand for the proposition that consideration at the beginning of the employment relationship is a "blank check" that stands as consideration for any subsequent agreement or modification. Instead, *Labriola* provides that even if there was consideration at the beginning of the employment relationship for a noncompetition agreement, any subsequent agreement or modification, after initial employment, must be supported by additional and independent consideration. *Labriola*, 152 Wn.2d at 836-838.

Moreover, whether any of the previous noncompetition covenants from 1992 through 2005 were supported by consideration is not germane to the question of whether there was consideration for the January 2007 noncompetition covenant. First and foremost, these are different agreements with different terms. As noted by the arbitrator in his Findings of Fact, from 1992 to 2007, the noncompetition covenant changed dramatically. CP 146-47. For example, the radius of the geographical restriction changed from 25 to 50 miles. CP 146-47. The liquidated damages provision increased, over time, from $3,500 per month for each month of breach, to $200,000, to ultimately $300,000 for any violation in the 2007 covenant. CP 146-147.

The agreement that Pilchuck sought to enforce in this case was not one of these prior agreements, but rather the January 2007 noncompetition covenant, which was both a subsequent agreement and a modification of previous noncompetition agreements (*see e.g.* 2005 vs 2007 noncompetition covenant, increasing liquidated damages from $200,000 to $300,000)(CP 147). As such, under *Labriola*, it needed to be supported by separate and independent consideration. This kind of separate and independent consideration, as defined in *Labriola*, was completely absent in this case. As a result, it was clear error, on the face of the award, for the arbitrator to find consideration for the January 2007 noncompetition covenant in the previous agreements of the parties and for the Trial Court not to vacate the award based on a lack of additional and independent consideration.

C. The arbitrator also erred as a matter of law in concluding that the promises of other shareholders to Pilchuck could serve as additional, independent consideration for the noncompetition covenant.

The arbitrator's finding of consideration for the 2007 noncompetition covenant also contained a second clear error of law on its face in the conclusion that the promises of the other Pilchuck shareholders could somehow serve as independent consideration for Salewski's January 2007 Agreement (let alone the 2008 agreement when Salewski again

became an employee.) There is no authority in Washington to support the arbitrator's conclusion that a promise by another shareholder (who is not a party to the agreement) is sufficient consideration for a noncompetition agreement entered into by a different individual after the start of his or her initial employment.

In finding consideration for the 2007 noncompetition provision, the arbitrator stated: "[t]he promises of the other shareholders were consideration for Plaintiff's promise." CP 148. But, this statement is both problematic and without support in Washington law. First, these "promises" were not promises that the other shareholders made to Salewski, but simply their own individual "promises" to Pilchuck in their own, separate, employment agreements. CP 147. No promises were made by the others shareholders to Salewski, nor were these individuals parties to any agreement between Salewski and Pilchuck.

Moreover, there is no authority in Washington law for the proposition that the independent promises of other shareholders in their own, separate, employment agreements, provides consideration for another individual's noncompete agreement. Under Washington law, independent consideration in noncompetition agreements may include increased wages, a promotion, a bonus, a fixed term of employment, or perhaps access to protected information. *Labriola*, 152 Wn.2d at 834

(citing *Schneller*, 176 Wash. at 118-19). There is no consideration when "one party is to perform some additional obligation while the other party is simply to perform that which he promised in the original contract." *Banchero*, 83 Wn.2d at 273 (citing 15 Walter H.E. Jaeger, Williston on Contracts § 1826 at 487 (3d ed.1972)). In short, there is no authority in Washington to support the proposition that the separate "promises" of other shareholders can stand as additional and independent consideration.

Recognizing this absence of authority in Washington law, Pilchuck urged the arbitrator and the Trial Court to find consideration for the noncompetition agreement not by applying Washington law, (in particular, the holding in *Labriola* and the authorities cited therein), but rather the application of a different test (set forth in the 1993 Georgia Court of Appeals case, *Pittman v. Harbin Clinic Professional Association*, 210 Ga. App. 767, 437 S.E.2d 619 (1993)), because the 2007 noncompetition agreement was entered into at a time when Dr. Salewski was a shareholder. While neither the arbitrator nor the Trial Court specifically cited *Pittman*, this is the only authority that either of the parties were able to locate marginally addressed this issue of consideration in the promises of other shareholders.

Although the issue of whether a promise by one shareholder to another (or more specifically, whether separate promises by shareholders

to the Company) can serve as consideration for another shareholder's noncompetition agreement appears to be one of first impression for the Courts of this state, this Court should reject such a conclusion, which would alter the framework for analyzing noncompetition agreements in Washington and make a distinction between noncompetition agreements entered into between employers and employees versus those entered into between or among partners or shareholders.

The Court need not change the framework of the analysis it has previously applied in noncompetition cases. Rather, the critical inquiry under Washington law should remain whether the agreement "unreasonably restrict[s] the freedom of current or former employees to earn a living." *Labriola*, 152 Wn.2d at 846-847 (Madsen, J., concurring). If the subject agreement unreasonably restrains an individual from his "lawful use of labor and skills," the agreement is unenforceable as a matter of law. *Id.* Nothing in *Labriola* or the cases decided before (or since) suggest the Washington Supreme Court would apply an alternative test, or weigh any of the relevant factors differently, simply because the party being asked to sign the agreement was a shareholder or partner.

In sum, the arbitrator erred as a matter of law both in concluding that the "promises" of other shareholders could serve as consideration for the January 2007 Agreement between Salewski and Pilchuck. Relying on

the framework previously set forth in *Labriola*, the arbitrator and the Trial Court should have assessed whether there was independent, additional consideration in the form of increased wages, a promotion, a bonus, a fixed term of employment, or access to protected information.

D. Both the Arbitrator and the Trial Court erred in failing to consider Salewski's change of employment status in 2008 and reasoning that under *Labriola*, continued employment served as sufficient consideration.

Both the arbitrator and the Trial Court made an additional clear error in finding consideration for the noncompetition covenant, in either ignoring (in the case of the arbitrator), or misconstruing (in the case of the Trial Court) the impact of Salewski's change of employment status in 2008 when he left the Pilchuck ownership group and again became an employee.

While noting this in his findings of fact, the arbitrator did not account for this change in Salewski's employment status, in itself an event which required additional, independent consideration for the subsequent noncompetition agreement to be enforceable. The Trial Court made a further error in analyzing this question, recognizing the importance of Salewski's change in employment status in 2008, but ultimately concluding that *Labriola* stood for the proposition that continued employment was sufficient consideration. CR 24.

In his award, the arbitrator noted (albeit briefly), the important fact that Salewski's employment status changed in 2008 when he went from being a shareholder in Pilchuck back to being an employee. CP 147.

The arbitrator found that in 2008, Salewski indicated that he wanted to leave the ownership group. CP 147. The arbitrator also found that as part of leaving the ownership group and again becoming an employee of Pilchuck, a stock redemption agreement was executed by Salewski and the remaining shareholders. CP 147. While it says so somewhat inelegantly, the arbitrator's Findings of Fact also reveal that the 2008 Stock Redemption Agreement entered into when Salewski became an employee did not contain a separate noncompetition agreement, but instead simply included reference to the 2007 noncompetition agreement as "remaining in effect." CP 147.

But short of enumerating these facts in the Findings of Fact, the arbitrator did not take into account whether this important change in Salewski's employment status from shareholder to employee required a new noncompetition agreement, or even new consideration for the previous agreement. In fact, the arbitrator engaged in no analysis as to whether this change in status impacted the need for additional, independent consideration, let alone should have an effect on the result. Instead, this critical fact was not even referenced in the arbitrator's

analysis of the question of consideration for the noncompetition covenant. CR 148.

While the Trial Court, in the context of reviewing the arbitrator's decision for clear error on its face in Appellant's Motion to Vacate, recognized the importance of this change in Salewski's employment status, the Trial Court then made an additional error, noting the change but reasoning that *Labriola* stood for the proposition that continued employment was sufficient consideration for the noncompetition agreement. CP 24. This was also clear error.

Unlike the arbitrator, the Trial Court noted that one of the key issues when it came to determining whether there adequate consideration for the noncompetition agreement was Salewski's change of employment status in 2008. The Trial Court noted:

> Between 2007 and 2010 something interesting happens, and this is something I also want to point out, that is his status changes from a shareholder with a paycheck to an employee, and that's very, very important I think also in the analysis.
>
> On December 31, 2008, he decides he wants to no longer be a shareholder, he wants to liquidate his stock, and there is an agreement that is made that liquidates the stock, reaffirms the noncompete clause, and gives him a paycheck.
>
> Once he goes from being a shareholder to being an employee, there are two considerations going on here: One, the original noncompete clause; and two, the noncompete clause that was reaffirmed, but his status changed. He's no longer a shareholder. He's an employee getting a paycheck. And in exchange for that

> paycheck, he agrees once again to the noncompete clause. There are really two potential considerations here that could be looked at.

CP 23:4-22.

But while the Trial Court isolated the correct issue when it came to assessing the question of consideration for the noncompetition covenant (i.e. was there consideration in 2008 when Salewski again became an employee), the Trial Court then reached the wrong answer by misconstruing *Labriola* and holding that continued employment does serve as consideration for a subsequent agreement. CP 24: 11-25.

The Trial Court noted:

> The case that I find really interesting, and I think we all do, is *Labriola*, because *Labriola* offers us two conflicting concepts of what consideration is that quite frankly does not really give us much guidance in this case of first impression. Over on Page 834 it says essentially that there has to be independent additional consideration when there are re-modifications of the original employment contract. And that additional consideration can be increased wages, promotion, bonus, a fixed terms of employment and so forth. It's on Page 834.
>
> The court goes on to say later on that, I think it's on Page 836, continued employment does serve, at least these promises, do serve as consideration. So you've got on Pages 836 to 838 a contradiction of what they really said. So the court doesn't really say that these sorts of things are not inconsistent with new consideration.
>
> So *Labriola*, if you really look at it closely, doesn't say what we all think it says. It really says I think that if your status changes, whatever is negotiated with respect to that employment status change, and here we have employee to shareholder employee back to employee, that creates a whole new set of promises, and by

> citing the noncompete clause that in and of itself is the consideration if I read the contradictions in *Labriola* correctly, which I did not, but that's how I read it.
>
> CP 24:11-25.

While the reasoning of the Trial Court in its colloquy is not perfectly clear, it would appear that the Trial Court concluded that there were inconsistencies in the holding of *Labriola*, with the Supreme Court stating at one point that there has to be independent, additional consideration when there are re-modifications of the original employment contract (the Trial Court's reference to the "page 834" analysis) and at another point saying that continued employment does serve as consideration (the Trial Court's "page 836" analysis.) CP 24.

Ultimately, the Trial Court appeared to conclude that the mere citation of the noncompetition clause in conjunction with Salewski's return back to an employee, "that, in and of itself is that consideration if I read the contradictions in *Labriola* correctly ...." CR 24. In short, the Trial Court appears to have settled on the conclusion that the reference to the previous noncompetition agreement, along with continued employment, was sufficient consideration.

But this conclusion is not consistent with the dictates of *Labriola.* In fact, Justice Madsen, in his concurrence, expressly addressed this type of situation, explaining that "[c]ontinued at-will employment, without

more, is never sufficient consideration for a noncompete agreement formed subsequent to employment." *Labriola*, at 844 (Madsen, J., concurring). The Trial Court's reading of *Labriola*, and its reliance on *Labriola* for the proposition that continued employment is sufficient consideration for a subsequent noncompetition agreement, misconstrues the case and was in clear error.

III. The Liquidated Damages Provision in the January 2007 Agreement is an unenforceable penalty under Washington law.

The Trial Court also erred in refusing to vacate the arbitrator's award on the ground that the liquidated damages provision that it upheld in the January 2007 Agreement was an unenforceable penalty. This liquidated damages clause provided for damages in the amount of $300,000 for any violation of an extremely broad noncompetition covenant. Rather than serving as a reasonable forecast of just compensation for the harm caused by a breach, this kind of an award is punitive in nature and it was clear error on the face of the award for the Trial Court to enforce it.

Washington Courts will not uphold a liquidated damages provision that constitutes a penalty or is otherwise unlawful. *Wallace Real Estate Inv., Inc. v. Groves*, 124 Wn.2d 881, 881 P.2d 1010 (1994). Washington Courts have traditionally applied a modified version of the two-part test

from the Restatement of Contracts, which looks at whether: (1) the amount fixed is a reasonable forecast of just compensation for harm caused by the breach, and (2) the harm is difficult to ascertain. *Watson v. Ingram*, 124 Wn.2d 845, 850, 881 P.2d 247 (1994). "The central inquiry is whether the specified liquidated damages were reasonable at the time of contract formation." *Id.* at 853.

Courts will construe liquidated damage clauses as penalties and refuse to enforce them if they are unreasonable or punitive in nature. *Wallace Real Estate*, 124 Wn.2d at 886. A penalty is punitive in nature, rather than an attempt to estimate damages in the event of a breach. "Its essence is a payment of money stipulated as *in terrorem* of the offending party, while the essence of liquidated damages is a genuine covenanted pre-estimate of damages." *Lind Building Corp. v. Pacific Bellevue Developments*, 55 Wn.App. 70, 75, 776 P.2d 977 (1989).

For example, in *Walter Implement Inc. v. Focht*, 107 Wn.2d 553, 730 P.2d 1340 (1987), the Washington Supreme Court found that a liquidated damages clause was a penalty and therefore unenforceable because the amount provided for as liquidated damages did not reflect a reasonable forecast of the harm that would be caused by the breach. That case dealt with leased equipment where the liquidated damages were 20 percent of the outstanding rental payments then due (the same amount as if

the lessee wished to purchase the equipment at the end of the lease term, except that it would be 20 percent of the entire lease figure). *Id.* at 558. The Court found that even if the variable was acceptable, no reasoning was offered to explain how the variation reflected a reasonable forecast of the harm that is caused by the breach. *Id.* at 561. Accordingly, the provision was held to be an unenforceable penalty rather than liquidated damages. *Id.* at 562.

In the employment context, reasonableness can be determined, for example, by an agreement that uses a formula that is based upon a percentage of competing business actually occurring. *See e.g. Knight, Vale and Gregory v. McDaniel*, 37 Wn.App. 366, 680 P.2d 448 (1984).

In *Knight*, an accounting firm sought enforcement of a noncompetition agreement against two accountants who left the firm. *Id.* at 367. The liquidated damages clause at issue required them to pay 35 percent of the gross proceeds derived from the firm's former clients. *Id.* at 371. The Court upheld the liquidated damages provision, noting the presence of an expert's uncontroverted affidavit that the damages sought were no more than a reasonable forecast of the harm to the employer occasioned by a breach; that the formula was based upon a percentage of competing business actually occurring and so was directly linked to the actual damage to good will experienced by the employer; and finally, the

figure was based upon a general formula in the accounting field for purchase of an ongoing practice. *Id.* at 371-72.

In this instance, there was no formula used by Pilchuck to provide a reasonable forecast of the harm that might occur in the event of a breach of the January 2007 noncompetition agreement. Not only did Pilchuck not use a formula (or any other methodology) in an effort to forecast potential harm from a violation, instead, Pilchuck did the exact opposite – selecting an arbitrarily high figure ($300,000), and then providing that an employee or shareholder would be the liable for that amount for any violation of what was an extremely broad noncompetition agreement, covering 50 miles over three years for patients with no relationship to employer and three years without geographical restriction as to patients formerly treated by Pilchuck. CR 147. This is precisely the kind of *in terrorem* clause that is designed to be punitive in nature, creating exposure exponentially in excess of the potential harm, rather than a reasonable forecast of damages.

It is undisputed that the January 2007 Agreement fixed the amount of liquidated damages at $300,000 for any single violation of the noncompetition covenant. Specifically, the January 2007 agreement provided that,

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> "Additionally, Employee agrees to pay liquidated damages in the amount of Three Hundred Thousand Dollars ($300,000) for any violation of the covenant not to compete."

CR 150.

It is further without dispute that this $300,000 liquidated damages figure was the amount for any, single violation of the noncompetition agreement at any time during the three-year period, whether inside the 50-mile geographic radius for a single patient who had no connection to Pilchuck, or without geographic bounds for anyone formerly treated at Pilchuck.

In analyzing whether the liquated damages clause was enforceable, the arbitrator engaged in, at best, a conclusory examination, reasoning that:

> Plaint [sic] has not persuaded this arbitrator that the liquidated damages amount was not a reasonable forecast of just compensation for the harm of violation of the non-compete agreement and was a mere penalty.

CR 150.

The arbitrator did not discuss, nor make any factual findings related to the fact that $300,000 for a single violation of a 50-mile noncompetition covenant was a reasonable forecast of damages. Instead, the arbitrator appeared to merely rely on the fact that the shareholders had previously agreed to raise the amount from $200,000 to $300,000, and

cited boilerplate language in the agreement that the liquidated damages clause was necessary and did not create an undue hardship.

The arbitrator concluded:

> This arbitrator is unable to conclude that is was a mere penalty in view of the fact that the shareholders had decided to increase the amount from $200,000 to $300,000 and declared that the terms of the agreement were necessary for the protection of the Defendant and that the non-compete provisions contained therein did not create any undue hardship for any of the shareholders.

CR 150.

The simple fact is that a $300,000 liquidated damages award for any single violation of a 3-year, 50-mile noncompetition agreement, particularly one that involves the performance of veterinary services, must *per se* be a penalty. There is no way that the $300,000 figure is a reasonable forecast of potential harm to Pilchuck for any breach of the agreement. Instead, given the lack of any meaningful basis on which the $300,000 figure is based, the liquidated damages clause must properly characterized as a penalty. As a result, the Trial Court erred in refusing to vacate the arbitration award as clearly erroneous on its face.

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CONCLUSION

For the reasons set forth above, Appellant respectfully requests that the judgment of the Trial Court be reversed and that the arbitration award entered on July 14, 2014 be vacated.

DATED this 12th day of December, 2014.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that the foregoing BRIEF OF APPELLANT was served on:

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by the following indicated method or methods:

_X_ by sending a full, true and correct copy thereof via **overnight courier** in a sealed, prepaid envelope, addressed to the attorney as shown above, to the last-known office address of the attorney, on the date set forth below.

Dated this 12th day of December, 2014.

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