No Sir! You Can't Steal My Clients! Or Maybe You Can: Effective Strategies for Preparing, Negotiating, Litigating and Avoiding Restrictive Covenants

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Sponsored by the Tort Trial and Insurance Practice Section ("TIPS"), the ABA Center for Professional Development and the TIPS Employment and Labor Law and Business Litigation Committees

Protecting Customer and Employee Relationships

- Covenants Not To Compete
- Non-Solicitation Agreements

Covenants Not To Compete

- What they do:
  - Contractual agreements where employee expressly agrees not to engage in certain activities that compete with her employer.
  - May apply during employment, after employment, or both.
  - Supplements duties otherwise existing under the law – i.e., common law duty of loyalty; fiduciary duties.

Non-Solicitation Agreements

- What they do:
  - Prohibit a departing employee from soliciting the company's customers
  - May also prohibit solicitation of employees
  - In determining enforceability, courts consider:
    - Was the employee aware of the restriction?
    - How curtailed are other employment opportunities?
    - Any unreasonable restraint on trade?

Covenants Not To Compete

- Enforceability:
  - Must bear reasonable relationship to employer's protectable interest in both the nature and scope of the restraint on the employee.
    - Restraints imposed on employee must be no greater than that required for the protection of employer
    - Must not impose undue hardship on employee
    - Must not be injurious to the public
    - Reasonable in time, territory and activity

Covenants Not To Compete

- Drafting Considerations:
  - Which State Law Will Apply?
  - Consideration?
- Consideration
  - Can't get something for nothing…
  - Generally have sufficient consideration if entered into at time of original employment contract and start of employment (Fifield v. Premier Dealer Services, Inc., 2003 IL App (1st) 120327)
  - If entered into after employment already commenced, then employer needs to provide something additional.
    - Promotion
    - Bonus
    - New benefits
    - Etc…
    - Fifield v. Premier Dealer Services, Inc., 2003 IL App (1st) 120327
  - Employer's Protectable Interest?
    - Reliable Fire Services Equipment Co. v. Arredondo, 2011 IL 111871
  - Time and Geographic Restrictions?

Covenants Not To Compete

- Which State Law Will Apply?
  - Some states are more hostile to these types of agreements and some are more receptive
    - California
    - Florida
  - Consider a choice-of-law provision and a venue provision
  - Presumption that state where services are performed is state having the most significant relationship to the transaction when issue concerns validity of covenant not to compete

Covenants Not To Compete

- Continued Employment Sufficient Consideration?
  - In a majority of states, employers need not provide existing employees additional consideration for entering into a non-compete covenant; the employee's continued employment is sufficient.
  - Some jurisdictions hold that continued employment is sufficient with certain caveats.
    - Washington D.C. (continued employment is sufficient if it is for a sufficient duration); Idaho (continued employment is sufficient but if no additional consideration, courts limit non-compete to 18 months).
  - In a minority of states, continued employment is not sufficient by itself
    - E.g., North Carolina, South Carolina

Covenants Not To Compete

- Intended Protected Employer Interest
  - Specifically identify the employer interest that the covenant is designed to protect:
    - Customer relationships
    - Confidential information
    - Good will
  - Why a “one size fits all” might not be appropriate

Covenants Not To Compete

- Intended Protected Employer Interest
  - Attorney needs to understand client's business and what is at issue
  - Usually courts only find a need for protection if:
    - Employee has access to trade secrets; or
    - Employee has access to confidential customer information or close relationships with customers and/or clients; or
    - Employee's services are special, extraordinary or unique

Covenants Not To Compete

- Time, Geographic and Activity Restrictions
  - No set rules; attorney must understand the applicable state law as well as the client's unique situation.
    - *But….* Generally most court's will enforce one to two years; three to four years more scrutiny; five years or more likely unenforceable
    - Area where employer conducts business and
    - Area where employee conducts business for employer
    - Activities similar to the activities employee performed for employers
  - Last only as long as the threat continues.

Exempted Professions and Lines of Work

- Attorneys should be aware that some jurisdictions exempt certain professions from non-compete covenants.
    - E.g., Texas (physicians); North Carolina (locksmiths); New Jersey (psychologists, in-house counsel); Massachusetts (broadcasters, social workers, nurses).

Covenants Not To Compete

- Consider conducting an exit interview with a departing employee depending on the circumstances.
  - Remind employee of the non-competition and any other similar agreements.
  - Find out where the employee is going.
  - Return of all equipment, documents, etc…
  - Have IT determine if anything funky going on … downloads, connections to devices, etc…
  - Have the employee sign an acknowledgement of obligations and return of property

Covenants Not To Compete

- Sale of Business
  - Special considerations in sale of business context
  - Generally can get away with more restrictions
  - Antitrust considerations may come into play

Non-Solicitation Agreements

- Enforceability:
  - Courts will enforce so long as the restrictions are reasonable to protect an employer's interest in its customers/employees, confidential information and trade secrets
  - Usually customers who the employee worked with or about when employee learned confidential information

Non-Solicitation Agreements

- Drafting Considerations:
  - Who is the employee?
    - Did the employee actually have contact with the customers
  - Who are the customers?
    - Does the employer have a “near-permanent” relationship with the customers
    - Can it be broken down by sales region, department, etc…
  - Time and Geographic restrictions.
    - Can vary by state, but may not need a geographic restriction

Judicial Modification of Non-Compete Provisions

- Attorneys must know not only how a court is likely to rule on the enforceability of a particular non-compete provision, but also what that court will do *after* it makes such a determination.

- In some jurisdictions, an overbroad non-compete might can be saved through judicial modification.

- When faced with an unreasonable non-compete clause, courts have 3 options, generally:
  - Blue Pencil
  - Red Pencil
  - Reformation

Red Pencil Doctrine

- The “all or nothing” rule.
- In Red Pencil jurisdictions, the court will simply throw out the entire covenant not to compete if the clause is held invalid.
- Less than 5 states expressly recognize a court’s red pencil power to the exclusion of the right to blue-pencil or reform an otherwise unenforceable non-compete agreement.
  - E.g., Nebraska
- Some state courts follow the red pencil rule with exceptions.
  - E.g., Virginia (severable portions can be enforced if remaining restrictions are otherwise enforceable)

Blue Pencil Doctrine

- The “divisibility” rule.

- In Blue Pencil jurisdictions, the court can save a non-compete provision by striking the overbroad terms that render it unenforceable.

- Approximately 15 states follow some form of the Blue Pencil rule.
  - A majority of these states follow the traditional blue pencil rule: the court only has the power to strike unenforceable provisions from a contract, not to rewrite them.
    - E.g., Georgia, Arizona
  - Some states follow the Blue Pencil rule with exceptions.
    - E.g., Louisiana (allows court to exercise blue pencil only if allowed by the non-compete)

Reformation

- Known as “judicial modification,” the “rule of reasonableness,” the “reasonable alteration approach,” and the “partial-enforcement” rule.

- In jurisdictions where reformation is recognized, courts have the power to re-write non-compete provisions that the Court deems overbroad or otherwise unenforceable, and to make the non-compete agreement enforceable under the law as the judge sees it.

- Reformation jurisdictions tend to be more employer friendly.

- Approximately 30 states follow the Reformation Rule.
  - E.g., Alabama, Florida

Litigating Non-Compete Claims

- Cease and Desist Correspondence
- Procedures for Separating Employee
- Ethical Issues When Representing Several Individuals
- Temporary Restraining Order

Litigating Non-Compete Claims

- Protecting Confidential Information and Trade Secrets
- Timing of Litigation
- Defenses to non-compete claims
- Damages and Other Relief
- Other Considerations

California's Peculiarities

- California Business and Professions Code section 16600 states as follows: "Every contract by which anyone is restrained from engaging in a lawful profession, trade or business of any kind is to that extent void.“
- This is true in California, even if the prohibition is limited to a certain geographic area or for a limited period of time.
- "The interests of the employee in his own mobility and betterment are deemed paramount to the competitive business interests of employers." *Application Group, Inc. v. Hunter Group*, 61 Cal. App. 4th 881, 900 (1998)

- Limited Exceptions
- There are specific circumstances where a California court will uphold a non-compete agreement. These include:
  - When a business owner sells a business
  - When a partnership ends or limited liability company dissolves

- CA courts can revise a restrictive covenant “only where the parties have made a mistake,” but “not for the purpose of saving an illegal contract.”

- California courts will not ‘blue pencil’ noncompete and nonsolicit provisions as this is viewed as undermining the policy of Section 16600
  - Employees would honor without questioning
  - Employers would have no disincentive to use broad illegal causes

- Other repercussions
- * A clause that is void under section 16600 may also violate California's Unfair Practices Act set forth in sections 17200 et seq. of the California Business and Professions Code
- * Section 16600 may also permit an employee to sue when he or she is terminated or denied employment for refusing to enter into an unlawful agreement.

- U.S. Court of Appeals for the Ninth Circuit concluded that a settlement agreement provision between a physician and his former employer constituted a "restraint of a substantial character" on the physician's medical practice and therefore violated California's non-compete provision, Cal. Bus. & Prof. Code § 16600. As a result, the entire settlement agreement was void and unenforceable. *Golden v. California Emergency Physicians Med. Grp.*, No. 16-17354 (9th Cir. July 24, 2018).

- **Takeaway from *Golden* is that a restraint on future employment deemed substantial (basically, anything other than re-employment with the same employer) is not beyond the restrictive scope of Section 16600, regardless of whether it is "reasonable" or narrowly tailored.**

- Non-Solicitation
- The enforceability of employee non-solicitation agreements under California law varies depending on the context of the agreement and the scope of the provision. Two main things courts will consider:
- Whether the contract is as lawful as reasonably possible; and
- The potential impact if the agreement is upheld or invalidated.

- Employee non-solicitation clauses should be:
  - narrow and a limited timeframe (1-2 years)
  - must not affect (or limit) other employees from subsequently working at the departed employee's new employer
  - must not prohibit other employees from contacting the departed employee or his or her new employer but may simply prohibit the departed employee from soliciting the employees

- Business or client non-solicitation clauses are generally given more latitude and are permitted to restrict departing employees from soliciting their former employers' customers or business. Frequently, courts will examine whether customer lists or other business information constitute trade secrets. If they do, then departing employees cannot use them for their own benefit or for the benefit of a third party, and a business non-solicitation limitation will be enforceable.

- Considerations for Out of State employers
- Labor Code Section 925 which applies to employment contracts entered into, modified, or extended **on or after January 1, 2017** provides in pertinent part as follows:
- (a) An employer shall not require an employee who primarily resides and works in California, as a condition of employment, to agree to a provision that would do either of the following:
- (1) Require the employee to adjudicate outside of California a claim arising in California.
- (2) Deprive the employee of the substantive protection of California law with respect to a controversy arising in California.

- A key exception to the application of Section 925 appears in subdivision (e):
- (e) This section shall not apply to a contract with an employee who is in fact individually represented by legal counsel in negotiating the terms of an agreement to designate either the venue or forum in which a controversy arising from the employment contract may be adjudicated or the choice of law to be applied.
- Thus, Section 925 generally forbids employers to require California employees to adjudicate claims outside of California or to submit to the laws of another state. An employee who successfully sues to void such offending provisions can recover reasonable attorney's fees. Lab. Code § 925(e).

- The risk posed by restrictive covenants extends beyond the employer's California employees. In *Application Group*, the court found that section 16600, and by extension section 17200, broadly applied to any "employment in California“ including:
  - (1) employees living in state;
  - (2) employees living out of state, but hired by California employers; and
  - (3) employees living out of state but performing services in state.
- Thus, the court in *Application Group* struck down the noncompete of a Maryland employer with a former employee living in Maryland who was hired by a California employer.

- What Can Be Done
- * ban only applies to post termination
- * non-disclosure agreements
  - - CA rejected “inevitable disclosure” doctrine
  - - restriction must be carefully limited/right protected by principles of unfair competition

  * non-solicitation clauses

- Additional considerations for Out of State Employers:
- * Make sure agreements comply with CA law
- * Can enforce in own state
  - - two lawsuits, messy
  - Deferred compensation
    - - plans governed by Federal Law (e.g. ERISA)
    - - “Garden Leave” plan
    - - Fixed term contract rather than At-Will