RESTRICTING EMPLOYEES FROM COMPETITION AND SOLICITATION: CONSIDERATIONS FOR COMPLYING WITH AND SEEKING TO ENFORCE RESTRICTIVE PROVISIONS IN AGREEMENTS

By: Jordan M. Segal

I. UNDERSTAND HOW TO CRAFT RESTRICTIVE COVENANTS IN EMPLOYMENT AGREEMENTS TO PROTECT VITAL BUSINESS INTERESTS

A. What is the definition and purpose of a Non-Compete Agreement or Clause?

1. An agreement or clause in a contract specifying that an employee must not enter into competition with an employer after the employment period is over.

2. A carefully crafted non-compete can prevent employees from being able to "sell" information for a new job at a competitor.

B. Although rules vary by jurisdiction, generally speaking there is a two-step process for a non-compete to be enforceable:

1. Step 1: Is the covenant tied to a ***Business Purpose?***

2. Step 2: Is the covenant reasonably limited as to:

a. Scope?

i. Define "Competition"; what does it mean to "Compete" with you? Actually, diverting business? Or, more broadly working with a company that does similar work to yours?

ii. In any event, the definition should give a general idea of the industry and types of businesses the employee agrees to not work in.

iii. Alternatively, list "hands-off" customers, competitors, vendors, suppliers or other relationships.

b. Geography?

i. Define a radius around your sites.

ii. Market Area.

iii. Jurisdiction.

iv. National.

v. Global.

c. Time?

i. Although the limitation must be specific to the situation, generally speaking 1-3 years is enforceable.

ii. Consider including a day-for-day extension for any period that the employee has breached the non-compete.

C. What is a "Reasonable" limitation? It depends based on the individual circumstances, along with the other restrictions on a sliding scale. In other words: **BE NARROW WHERE YOU CAN BE, SO YOU CAN BE BROADER WHERE YOU WANT TO BE.**

D. What if you overreach? Jurisdictions generally utilize three types of remedies:

1. **Blue Pencil:** The Court will re-write the terms of the non-compete clause to be more reasonable.

2. **Reformation**: The Court can re-write *the entire agreement* to attempt to capture the intent of the parties. This may include re-writing other terms that have nothing to do with non-competition.

3. **Red Pencil**: An agreement containing an overly-broad non-compete provision is *void* or *voidable*, whether in whole or in part.

E. Non-Compete Agreements vs. No-Poaching Agreements.

1. To be enforceable, a non-compete **must** be between an employer and its employee.

2. Agreements between competitors not to hire each other's employees are not enforceable and very likely a violation of anti-trust laws. In 2015, Google and Apple learned this the hard way, and had to settle a lawsuit for more than $400 million!

II. LEARN ABOUT ALTERNATIVES TO NON-COMPETITION PROVISIONS – AND WHEN TO USE THEM

A. Three reason why an employer might elect not to use non-compete agreements?

1. *You Can't:* Non-compete agreements are not permitted in every state, and some states limit when non-compete agreements can be used.

a. Many states outright ban non-compete agreements or, at least, ban the use in the employment context. California is the biggest example of this. See also D.C. and Oklahoma.

b. Many other states will limit the use of non-compete agreements. These limitations may a salary or wage floor, under which a non-compete agreement is not permitted. Other limitations might be by industry. Colorado, Delaware, Massachusetts, New Hampshire, New Mexico, and South Dakota prohibit non-compete agreements for physicians or certain medical practitioners. New Jersey also prohibits non-compete agreements for psychologists.

c. There is a special problem with regard to hybrid or remote employees who live or work across state lines. The question of what law applies: the law of the employer's state or the employee's state. The rise of remote work has complicated this, and the law is not always clear.

2. *Use It or Lose It*: If you are not prepared to enforce your non-compete agreements in court, you may waive your rights. This can be worse than not having a non-compete in the first place. Failing to enforce a non-compete agreement can give future employees two potential defenses:

a. *Legal argument*. The employer has waived its contractual rights under the non-compete agreement by signaling to employees that it will not do so.

b. *Factual argument.* The employer is not seeking to protect a business interest because if it were, it would have enforced its contractual rights in other cases.

3. *Misuse It and Lose It*: Overuse of non-compete agreements is causing increased scrutiny and may result in legal limitations on non-compete agreements.

a. The data is clear: Employers are overusing non-compete agreements. According to a 2019 National Survey performed for a Whitehouse working group, almost a third of American employees are subject to some form of non-compete agreement.

b. Jimmy John's is a cautionary tale, even though its non-compete agreements *were upheld as enforceable* in Illinois, a subsequent antitrust lawsuit brought by the state attorney general resulted in an undisclosed settlement and a promise to "voluntarily" cease the use of non-compete agreements to protect the proprietary business interest in putting sliced meat between pieces of bread. *See Illinois v. Jimmy John's Enterprise, LLC.*, 2016 CCH 07746 at 17.

c. State regulatory and legislative trend across the country is to limit or ban the use of non-compete agreements. The Federal Government is looking into national rules through the NLRB, CFPB, DOL, and other agencies.

B. Alternatives to Non-Compete Agreements.

1. **Garden Leave**: This is more common in the U.K. than in the U.S. although sometimes used in investment banking or financial services in the U.S. An employer requests that an employee, upon submitting their notice, need not return to the office. This is a type of absence where an

employee is asked not to work during their notice period, in anticipation of their departure, while still being kept on the payroll, and still subject to a "during employment only" non-compete agreement. Effectively, the employer is buying the non-competition period.

2. **Severance forfeiture or claw-back:** The Employee is offered a substantial sum of money, but if they work for a competitor, they forfeit some or all of the payment. Just like in Garden Leave, the employer is effectively "buying" non-competition. These policies or agreements are generally are much more palatable to courts who are otherwise hostile to non-compete agreements. However, they are voluntary, so an employee might not agree and could choose to forego the severance. Second, they are difficult to collect. Finally, there can be tax implications of a delayed payment if it is not structured correctly.

3. **Fee Splitting**: In most states where non-compete agreements are not enforceable, it is still permissible to agree to split post-termination fees in the event of competition. For example, if an employee goes to work for a competitor and the old employer's customers follow, the employee must contribute (for example) 50% of fees generated by those customers. While more legally palatable in some states, this may be practically difficult to enforce. Some employers view this as permitting an employee to "buy their way out of a non-compete agreement"

4. **Non-Solicitation and Confidentiality/NDA's:** Except in very specific and limited circumstances, NDAs and confidentiality agreements almost universally enforceable. Sometimes non-solicitation agreements are subject to the same rules as non-compete agreements, and sometimes they are more generally available. In either case, these agreements protect your *data* in a more targeted way than banning the employee from working for a competitor.

III. ESTABLISHING CLAIMS AND DEFENSES RELATED TO BREACH OF A RESTRICTIVE COVENANT

A. What to do if you suspect a breach?

1. **ENGAGE LEGAL COUNSEL ASAP!** The quicker you move, the better off you will be. The longer you wait, the more likely data transfer can occur.

2. Hopefully, your documents and agreements are in order. Once you are in a dispute, your agreements say what they say. The best time to review your non-compete agreements is ***before*** a dispute arises.

3. Protect your important relationships. Notify vendors and customers. Monitor your relationships. Minimize potential damage and exposures.

4. Did the former employee actually violate the non-compete? Who did the employee sign on with. Do they compete with you?

5. Look for evidence on your systems: emails, activity logs, etc.

6. Send demand letters to the new employer and former employee. Legal counsel's first step will likely be to evaluate underlying agreements, understand circumstances, identify claims, and send a demand letter to both the former employee and new employer.

B. Former Employer's Claims Against Employee

1. Breach of agreement.

2. Violation of fiduciary duties as an employee.

3. Violation of confidentiality obligations (under contract and common law).

C. Former Employer's Claims Against New Employer

1. Unlawful interference with business or contractual expectations.

D. Employee Claims Against Former and New Employer

1. Possible claims against former employer:

a. Non-compete agreement unlawfully overbroad (*e.g.*, no legitimate business interest protected; too broad geographically; too long in duration).

b. Violation of agreement to pay severance during the restrictive period, if there is such an agreement.

2. Possible claims against new employer:

a. If disclosed agreement and requested indemnification from the new employer in the event of dispute, possible request for enforcement of indemnification.

3. *Reality is that typically an employee and new employer may present a joint defense, either through joint counsel or separate counsel.*

E. New Employer's strategies and defenses: What happens if you have employed someone who is subject to a non-compete agreement?

1. **ENGAGE LEGAL COUNSEL ASAP!** There is a real risk of liability!

2. Require disclosure of restrictive covenants as part of your hiring process.

3. Don't make things worse by creating additional claims.

4. Conduct an honest assessment of how important the new employee is to your business, whether there is a role for the new employee without infringing on restrictions, and how likely the old employer is to fight.