



RESTRICTIVE COVENANTS FOR **EMPLOYEES**

Primerus Business Law Institute
Commercial Law Group

JUNE 8, 2011

The Webinar will begin shortly.

RESTRICTIVE COVENANTS FOR EMPLOYEES



Drafting Considerations Enforcement and Defense Unique Issues - - California and Beyond

James D. Vail - Schneider, Smeltz, Ranney & LaFond P.L.L.

Steven J. Rotunno - Kubasiak, Fylstra, Thorpe & Rotunno, P.C.

Darryl J. Horowitt - Coleman & Horowitt, LLP

RESTRICTIVE COVENANTS FOR EMPLOYEES



- I. Restrictive Covenants: Types, Concerns, Key Provisions, and Tax Considerations
- II. Enforcement of Restrictive Covenants - - the Legal Requirements - - and How to Avoid (Hopefully) Being Trapped by Them
- III. The Unique Issues Effecting Restrictive Covenants - - Particularly in California

Drafting Considerations



James D. Vail
Schneider, Smeltz Ranney & LaFond P.L.L.
1111 Superior Ave Suite 1000
Cleveland, OH 44114
jvail@ssrl.com
216-696-4200

Typical restrictive covenants



Covenant not to compete;

Covenant to not solicit customers, prospects
or employees;

Covenant to not disclose proprietary
information.



Typical employer goals/concerns

Prevent unfair competition

- Including improper use of employer's goodwill and customer relationships;

Protect proprietary information;

Protect business relationships with customers, vendors and other employees.

Non-Solicitation v. Noncompetition



Non-solicitation agreement is typically easier to enforce, but may be more difficult to police.

Trade Secrets



Restrictive covenants integrate with trade secret protection available to the employer;

Restrictive covenants demonstrate the employer's effort to protect its trade secrets.

Comparison with Trade Secret Law



Contractual restrictive covenant, as opposed to common law or trade secret claims, has the advantage of:

- permitting a court to analyze the conduct under a breach of contract approach, rather than a statutory/tort analysis;
- causing employee to be bound by “honor”.



Key Provisions

Tolling provision;

No defense for delay of enforcement ;

Define “prospect” carefully;

Term – 1-2 years ;

Geographic scope – needs to be reasonable in light of employee’s duties and employer’s business;

Allowing employee to compete, but not solicit, typically allows for a longer term.

Key Provisions



- Choice of law and forum;
- Require disclosure of covenant to new employer;
- Exclude enforcement of the covenant from arbitration provision;
- Attorney fees to prevailing party;
- Assignability of restrictive covenant may enhance the value of the company in an exit;
- Assignment of covenant may terminate the restriction (can serve as poison pill);
- Require return of employer materials;
- Acknowledgement of restrictive covenants at the exit interview.

Reasonableness & Tailoring



Consider different type of agreements for different level employees.

Enforcement by Jurisdiction



Enforceability of employee restrictive covenant varies by jurisdiction;

California, Alabama, Colorado, North and South Dakota, Florida, Louisiana, Michigan, Montana, Oregon, Texas and Louisiana limit the enforceability of employee restrictive covenants.

Enforcement by Jurisdiction



In “at will” states, additional consideration is generally not required in continuing-employment situations.

Business Acquisition



Restrictive covenants in the context of business acquisitions are much more likely to be enforced, and for longer time periods, than those merely arising out of employment agreements.

Tax Allocation Issues



Consider the tax consequence of a non-compete in the context of an acquisition.

- Ordinary income to seller;
- Buyer amortizes over 15 years.

Enforcement Issues



Remedies – injunction (sometimes a TRO, sometimes only a preliminary injunction – depending on how egregious the behavior and the harm).

Enforcement Issues



Court's reluctance to enforce; need to show harm or risk of harm – unfair competition, not just competition;

- Balancing test – how much harm will the employer likely suffer compared to the employee's inability to earn a living.

Enforcement Issues



Some areas of employment are exempt from restriction in different jurisdictions, e.g. law and medicine.

Enforcement and Defense



Steven J. Rotunno
Kubasiak, Fylstra, Thorpe & Rotunno, P.C.
20 South Clark St Suite 2900
Chicago, IL 60603
srotunno@kftrlaw.com
312-630-9600

ENFORCING AND DEFENDING RESTRICTIVE COVENANTS



*What Relief You Can Receive

*What You Need To Prove To Obtain That Relief

*How Can You Avoid The Restrictions

THE TYPES OF RELIEF YOU CAN RECEIVE WHEN YOU ENFORCE A RESTRICTIVE COVENANT



1. Temporary Restraining Order.

- *Seek immediate relief (within days) of a breach, or threatened breach, of a restrictive covenant

- *To prevent dissemination or use of confidential information

- *To prevent actual or likely solicitation of your customers

- *To prevent former employee and/or his/her new employer from accepting business from your customers

- *Generally, based upon:

- Complaint

- Motion for TRO and Memorandum in Support

- Affidavits/Declarations

- Opponent's Memorandum

- Opponent's Declarations/Affidavits

- Oral Argument, with no Evidentiary Hearing

THE TYPES OF RELIEF YOU CAN RECEIVE WHEN YOU ENFORCE A RESTRICTIVE COVENANT



- * May be issued without notice, if:
 - giving notice to adverse party will cause irreparable injury or loss
 - Advise court that notice attempted, but it was not successful

- * Limited in Scope (Fed.R.Civ.P. 65)
 - 10 days
 - One extension of 10 days
 - Agreement of parties to extend for a longer period of time

THE TYPES OF RELIEF YOU CAN RECEIVE WHEN YOU ENFORCE A RESTRICTIVE COVENANT



2. Preliminary Injunction.

- *Same relief as a TRO, except the parties engage in expedited discovery
- *Then, there is an evidentiary hearing
- *Generally, hearing within 20 days of TRO, if TRO granted
- *If TRO denied, PI hearing within a few months
- *A good way to “expedite” trial of the case
 - most trials do not change the ruling on the Preliminary Injunction Motion
- *Seeking injunctive relief is one strategy to deal with a former employee’s misconduct

THE TYPES OF RELIEF YOU CAN RECEIVE WHEN YOU ENFORCE A RESTRICTIVE COVENANT



3. Trial for a permanent injunction and damages.
 - *Like any other trial
 - *Seeks to restrain the ex-employee from violating the restrictive the day of the court's ruling
 - *can combine claims for money damages at the same time
 - *Risky to **only** seek a permanent injunction and not preliminary or temporary injunctive relief
 - *Shows injunction may not be necessary to protect your business
 - *Shows damages are the only relief you really need for violations of the type of restrictive covenant at issue

THE TYPES OF RELIEF YOU CAN RECEIVE WHEN YOU ENFORCE A RESTRICTIVE COVENANT



4. Suit against the new employer for inducing former employee to breach his/her restrictive covenant.
 - *Drag new employer into the public arena by adding company as a named defendant in a lawsuit
 - strategy decision
 - A public lawsuit may cause new employer to resolve the case more quickly
 - *Ability to get an injunction directly against the new employer to prevent accepting business separate from an injunction against the ex-employee
 - may effectively get a non-compete order from a breach of a non-solicitation agreement!!

PROVING A VIOLATION OF A RESTRICTIVE COVENANT



1. Does the employee's conduct actually violate the restrictive covenant.
 - *Non-Competition vs. Non-Solicitation vs. Non-Contact
 - *Did the ex-employee disclose confidential or proprietary (trade secret) information
 - is the information in the public domain
 - does the party who gets the CI already have it
2. Did the ex-employee acquire trade secret or other confidential information through his/her employment.
3. Did the employee try to use this confidential or proprietary information for his/her own benefit.

PROVING A VIOLATION OF A RESTRICTIVE COVENANT



4. Are the customer relationships “near-permanent” and but for the ex-employee’s association with the employer, the employee would not have had contact with the customers.
 - *Facts to show a “near-permanent” relationship:
 - the expense and effort invested to develop and maintain customers
 - the amount and frequency of personal contact by the employer with the customers
 - the extent of the employee’s knowledge of the customers’ buying habits and their current and future requirements
 - the continuity and duration of the business relationships in relation to the length of time the employer has been in business
 - *All types of customer relationships have been shown to be near-permanent
 - doctor/patient
 - stock broker or insurance broker/client
 - manufacturer/customer
 - service provider/customer
 - *It is easier to enforce a restrictive covenant where there is a personal relationship between the employer and the customer versus a relationship between an employer and a customer who purchases a recognizable commodity; but, the restriction can still be enforced
5. For a sale of business situation, much easier to enforce non-competition and non-solicitation agreements.

INJUNCTIVE RELIEF - - THE CRITERIA NECESSARY TO OBTAIN AN INJUNCTION



1. A reasonable likelihood of success on the merits.
2. No adequate remedy at law.
3. Irreparable harm will occur if no injunction is granted.
4. The balance of harms counsels towards granting the injunction.
5. The public interest will not be harmed.

LIKELIHOOD OF SUCCESS ON THE MERITS



1. For a TRO, only a better than negligible chance of succeeding on the merits of your claim is necessary.
2. Fact-specific determination.
3. You must proffer real evidence of the conduct which constitutes the violation of the restrictive covenant.
 - *supposition is generally not enough
4. Is the restrictive covenant enforceable.
 - *Meets with public policy
 - *Limited in time
 - *Limited in geographic scope

NO ADEQUATE REMEDY AT LAW



1. Money damages are difficult to prove.
2. Cannot remedy the employer's reputation.
3. Cannot quantify employer's loss of goodwill.
4. Many restrictive covenant agreements state that the employee acknowledges that money damages are not adequate for a breach.

IRREPARABLE HARM



1. Often acknowledged in the restrictive covenant.
2. Cannot reverse the harm without an injunction.
 - *A client cannot be “unsolicited”
 - *Confidential information cannot be removed from a competitor’s knowledge
 - *Customers who transfer their business are lost

THE BALANCE OF HARMS AND LACK OF DAMAGE TO THE PUBLIC COUNSEL FOR INJUNCTIVE RELIEF



1. A balancing test.
 - *what does the employer lose versus
 - *what benefits has the ex-employee already received and will receive in the future
2. Can the ex-employee still “earn a living” or has he/she received significant benefits from the sale of a business.
3. Are customers really harmed by enforcing the restrictive covenant.
 - *Usually, only a temporary loss of the ex-employee’s services
4. Need to enforce contracts freely entered into by the parties.

AVOIDING THE EFFECTS OF RESTRICTIVE COVENANTS AND DEFENDING ENFORCEMENT ACTIONS



1. Attack the legal sufficiency of the restrictions.
2. Do not undertake the impermissible conduct.
3. Make the former employer prove all criteria needed to get injunctive relief.
4. Do not assist your new employee in violating the restrictions.

THE LEGAL SUFFICIENCY OF THE RESTRICTIVE COVENANTS



1. Governed by State law.
 - *Determine what state law applies
2. Examine the “industry” since there are often unique issues in an industry.
 - *Financial services
 - FINRA rules
 - *Personal services
 - doctors
 - accountants
 - lawyers
 - *Are fiduciary duties involved
 - *The type of commodity sold or service provided
3. A “legitimate business” interest cannot be proved by the former employer to support the restrictive covenant.
 - *Restrictive covenants are generally disfavored as a restraint on trade
 - *Protection from competition, alone, is not a “legitimate business interest” warranting injunctive relief
 - *Is the alleged confidential information really confidential and not just “general knowledge” or already in the public domain

THE CONDUCT AT ISSUE DOES NOT VIOLATE THE RESTRICTIONS



1. If there is a non-compete agreement, it is difficult to show the conduct does not violate the agreement once the former employee is employed by a competitor.
2. If a non-solicitation agreement, there is a difference between solicitation and “announcing” the former employee’s new affiliation with your company.
 - *Announcement cards
 - *Trade publication articles and announcements
 - *LinkedIn announcements
 - *Can provide information about your company if the customer asks for it
 - *Courts do look at the language in the announcement to see if it contains a solicitation
 - easier to find no solicitation when the business involves personal relationships between the employee and customer
3. The former employee should not take confidential information with him or her.
 - *Delete information from home computers, lap tops and PDAs
 - *Do not download information and transfer it to another site before resignation

NEW EMPLOYERS NEED TO AVOID ASSISTING THEIR NEW EMPLOYEE'S VIOLATIONS OF A RESTRICTIVE COVENANT



1. Avoid a claim for intentional interference with breach of your new employee's restrictive covenant agreement.
 - *Have new employee confirm in writing whether he or she has a restrictive covenant
 - *Get a copy of the agreement and determine what conduct is prohibited
 - *Make sure the new employee has an attorney to counsel him or her as to what conduct or action can or cannot be undertaken
 - *Do not provide assistance to new employee if he or she attempts to violate the restrictions
2. Do not accept confidential information from the former employer.
3. Avoid an injunction against the new employer directly, separate and apart from one against the employee, for inducing the breach of the restrictive covenant since the injunction is, essentially, a non-compete entered against the new employer.
 - *Many courts believe that the only effective injunctive relief is to prevent the new employer from accepting business from customers of the former employer, even if the customers came without assistance from the new employee.

THE FORMER EMPLOYER MUST PROVE ALL OF THE ELEMENTS TO OBTAIN AN INJUNCTION



1. In defending a restrictive covenant case, show that there is no evidence, versus conjecture or supposition, that the former employer has a legitimate business interest to protect since there is no proof of:
 - *A “near permanent” customer relationship, or
 - *Confidential information being used for the former employee’s benefit

2. Show that there is no real evidence of a solicitation.
 - *Different than an “announcement” of a new employment position
 - *Need to show, by competent evidence, that the former employee asked the customer to do business with his or her new employer

3. Is there evidence that a trade secret/confidential information was misappropriated and used by the former employee for his or her benefit.

THE FORMER EMPLOYER MUST PROVE ALL OF THE ELEMENTS TO OBTAIN AN INJUNCTION



4. Can money damages really satisfy the former employer.

- *The former employer can still compete, particularly if a mere commodity is at issue

- *The restriction is short in duration so to deprive the customer of choice would not be appropriate

5. Are the equities in favor of the former employee and the public.

- *Deprived of an opportunity to earn a living

- *The public's choice is truly infringed upon

Unique Issues - - California and Beyond



Darryl J. Horowitz
Coleman & Horowitz, LLP
499 W. Shaw Ave Suite 116
Fresno, CA 93704
djforowitz@ch-law.com
559-248-4820



**COVENANTS NOT TO COMPETE
IN CALIFORNIA:
ARE THEY DIFFERENT IN THE
GOLDEN STATE?**

CALIFORNIA'S PUBLIC POLICY



1. What is the public policy ? Simple, such covenants are *void*
Against Public Policy
 - A. Where can this be found? - California Business & Professions (“B&P”) Code § 16600
 - B. What B&P § 16600 says:

“Except as provided in this chapter, every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void.”

HOW THE PUBLIC POLICY IS INTERPRETED



1. Section 16600 has been interpreted rigidly on grounds that it represents a strong public policy in favor of open competition and employee mobility (*D'sa v. Playhut, Inc.* (2000) 85 Cal.App.4th 927, 933). It ensures that every citizen shall retain the right to pursue any lawful employment and enterprise of their choice. (*Edwards v. Arther Andersen, LLP* (2008) 44 Cal.4th 937, 946 [*Edwards*].)

2. What the courts say:
 - a. Section 16600 prohibits employee noncompetition agreements (*Edwards*. at p. 941-948.)

 - b. *Any* agreement that restricts an employee from soliciting or performing work for former clients was a restriction on the ability to practice a profession and was therefore invalid. (*Ibid.*)

3. In *Edwards*, the California Supreme Court held that 16600 is unambiguous, that it was not limited to restraints that were unreasonable or overbroad, and that there was no narrow-restraint exception. (*Id.*, at pp. 948-950.)

WHAT IS CONSIDERED A COVENANT



1. A specific provision in a contract or manual (employment, purchase and sale agreement, employment manual, etc.) that provides that an employee will not compete against his/her employer if he/she leaves (or even while employed)
2. An anti-solicitation of business clause in an employment agreement/manual.
3. A provision in an agreement that requires an employee to pay a portion of monies received from a former customer/client

ARE ALL SUCH PROVISIONS VOID OR ARE THERE EXCEPTIONS?



1. Sale of interest in corporation - B&P 16601

Any person who sells the goodwill of a business, or any owner of a business entity selling or otherwise disposing of all of his or her ownership interest in the business entity, or any owner of a business entity that sells (a) all or substantially all of its operating assets together with the goodwill of the business entity, (b) all or substantially all of the operating assets of a division or a subsidiary of the business entity together with the goodwill of that division or subsidiary, or (c) all of the ownership interest of any subsidiary, may agree with the buyer to refrain from carrying on a similar business within a specified geographic area in which the business so sold, or that of the business entity, division, or subsidiary has been carried on, so long as the buyer, or any person deriving title to the goodwill or ownership interest from the buyer, carries on a like business therein.

ARE ALL SUCH PROVISIONS VOID OR ARE THERE EXCEPTIONS?



2. Sale of interest in partnership - B&P 16602

(a) Any partner may, upon or in anticipation of any of the circumstances described in subdivision (b), agree that he or she will not carry on a similar business within a specified geographic area where the partnership business has been transacted, so long as any other member of the partnership, or any person deriving title to the business or its goodwill from any such other member of the partnership, carries on a like business therein.

(b) Subdivision (a) applies to either of the following circumstances:

(1) A dissolution of the partnership.

(2) Dissociation of the partner from the partnership.

ARE ALL SUCH PROVISIONS VOID OR ARE THERE EXCEPTIONS?



3. Sale of interest in LLC - B&P 16602.5

Any member may, upon or in anticipation of a dissolution of, or the termination of his or her interest in, a limited liability company (including a series of a limited liability company formed under the laws of a jurisdiction recognizing such a series), agree that he or she or it will not carry on a similar business within a specified geographic area where the limited liability company business has been transacted, so long as any other member of the limited liability company, or any person deriving title to the business or its goodwill from any such other member of the limited liability company, carries on a like business therein.

ARE THERE ANY RESTRICTIONS IF A VALID COVENANT IS FOUND TO EXIST?



1. Geographic area
2. Term
3. Subsequent sale of business to whom a covenant was provided. (See B&P 16601, 16602 and 16602.5.)
4. Where the purchaser of the covenant leaves the business that was to be protected by the covenant or the business otherwise closes. (*Ibid.*)

OTHER WAYS TO PROTECT YOUR COMPANY WHERE A COVENANT CANNOT BE HAD



1. Protection under the Uniform Trade Secrets Act

a. But courts have held that injunction may not issue if it would serve as an otherwise invalid covenant not to compete

b. See *The Retirement Group, Inc. v. Galante* (2009) 176 Cal.App.4th 1226, 1238 and *Dowell v. Biosense Webster, Inc.* (2009) 179 Cal.App.4th 561.

LIMITATIONS TO INJUNCTIVE RELIEF



1. California courts *do not* apply doctrine of inevitable disclosure

2. Need Strong Evidence of Future Use of Trade Secret.
 - A. Where a party testifies that there will be no further use of an alleged trade secret and there is no evidence that such future use will occur, an injunction may not issue. (*East Bay Mun. Utility Dist. v. Department of Forestry & Fire Protection* (1996) 43 Cal.App.4th 1113.)
 - B. As the court stated in *East Bay*:
"An injunction properly issues only where the right to be protected is clear, injury is impending and so immediately likely as only to be avoided by issuance of the injunction. (*City of Tiburon v. Northwestern Pac. R.R. Co.* (1970) 4 Cal.App.3d 160, 179.) A corollary of this rule is that a change in circumstances which renders injunctive relief unnecessary justifies denial of the remedy. (*Donald v. Cafe Royale, Inc.* (1990) 218 Cal.App.3d 168, 184.) An injunction should not issue as a remedy for past acts which are not likely to recur." (*Ibid.*; *East Bay* at p. 1126.)
 - C. There must be proof that there is a likelihood that the defendant might use the list in the future. (*East Bay, supra*; *Spielman Motor Co. v. Dodge* (1935) 295 U.S. 89, 95; *Northport Power & Light Co. v. Hartley* (1931) 283 U.S. 568, [There must be clear and immediate danger or threat of real, not merely apprehended interference].)

ADDITIONAL LIMITATIONS TO INJUNCTIVE RELIEF



1. Any injunction that has the effect of restricting ones ability to engage in their chosen profession must be carefully drafted, even if it is to protect trade secrets.

- A. *The Retirement Group, Inc. v. Galante* (2009) 176 Cal.App.4th 1226, 1238 [portion of a trial court injunction struck which restricted directly or indirectly soliciting any of the former employers clients on grounds that such were protected trade secrets]
- B. *Dowell v. Biosense Webster, Inc.* (2009) 179 Cal.App.4th 561 [covenant not to complete and non-solicitation provision not enforceable even if characterized as protecting trade secrets].).

WHAT IF THE EMPLOYEE, LOCATED IN CALIFORNIA SIGNS AN AGREEMENT THAT ADOPTS THE LAW OF ANOTHER STATE THAT PERMITS RESTRICTIVE COVENANTS?



1. No protection afforded
2. California courts hold that the interest of the state in protecting its employees override the forum selection/choice of laws provisions
3. California courts may even apply such protections to employees who normally work a state that permits restrictive covenants but are temporarily working in California
 - A. Recent decision applied California wage and hours laws to employees temporarily working in California



QUESTIONS?



- **To learn more about the Primerus Commercial Law Practice Group or to find a Primerus Commercial Law Attorney near you, please**
- **Visit www.primerus.com/commercial-law-practice-group.htm**
- **To learn more about the International Society of Primerus Law Firms, please visit www.primerus.com.**