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Non-Competition Agreements Work and are a Powerful Business Tool

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Non-Competes are Alive and Well

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America has a love-hate relationship with non-compete and non-solicitation agreements. On the one hand, they are viewed as essential tools to preclude unfair competition by providing a buffer of time between an employee ending one job and starting another. On the other hand, they are viewed as an overused, inherent restraint of trade because they impair worker mobility to new and perhaps higher paying jobs within their industry as well as limit the ability of clients and customers to work with the individual of their choice. The politics, economic policy and increasing amount of litigation surrounding non-competes have kept restrictive covenants in the news. The goal of this webinar is to discuss the current state of non-competes and to demonstrate that with the exception of the jurisdictions in which they are banned — California, Oklahoma, North Dakota, and the District of Columbia — non-competes remain viable and enforceable given the proper drafting and facts.

A Review of the Basics

With some exceptions, the law surrounding non-competes is relatively uniform among the states. To be enforceable in most jurisdictions a non-compete agreement has to be reasonable in time and area, necessary to protect the employer's legitimate interests and, at least in New York, "not harmful to the general public and not unreasonably burdensome to the employee." *Reed, Roberts Associates, Inc. v. Strauma*n 40 N.Y2d, 303, 307 (1976). Of course, the satisfaction of these simple-sounding elements of necessity, scope and time is dependent on the facts, the terms of the agreement, applicable law, adequacy of counsel, the predilections of a particular court or judge, and today maybe even politics.

Breach of non-compete litigation tends to be fast and furious and usually starts with a motion for a temporary restraining order, or at the very least a motion for preliminary injunction via an order to show cause. Non-competes are commonly misunderstood instruments and as a result the expectations of their drafters and the employers who issue them are often not realized. Less savvy lawyers often claim that "they are not worth the paper they are written on," which is simply not true. Practitioners in this area of the law know they will rarely get strict enforcement of a particular agreement. Restrictive covenant agreements are, in practical terms, only an entry ticket to the courtroom. Most employers don't understand or forget that; to them a contract is a contract. Yet, what happens in the courtroom depends on the satisfaction of the factors outlined above and whether a court can or is of the mindset to blue pencil and conform the agreement to the facts and circumstances of a given case. Unless the facts are truly extreme, such as an employee about to work for a direct competitor is suspected of misappropriating critical trade secret information or the emergency need to stop a former VP of sales from soliciting key clients, movants know that they often face an uphill battle. This is because of the court's legitimate concern that enforcing a non-compete may have profound consequences on the employee, such as loss of income, reputation, or the employee becoming "stale" and unemployable in fast-moving industries such as tech or medicine.

A figurative "blue pencil" is the tool courts use to adjust or limit the scope of an overly broad restrictive covenant. Applying law and the court's sense of what is reasonable, the unenforceable or offending parts of the contract are invalidated either by striking them from the agreement or revising them to fit the circumstances. For example, limiting a one-year non-compete to three months or limiting the scope of a non-solicit from "all customers" to just those serviced by the defendant. A court's ability to blue pencil may vary from state to state and may be regulated by state statute or common law.

Federal Action Regarding Non-Competes

The appropriateness of non-competes and their impact on employee mobility and wages has been the subject of state legislation and federal commentary and investigation; much of it focused on industries that require low skill, low-wage workers. Jimmy Johns, for example, required employees to sign agreements that barred them from taking jobs with competitors for two years after leaving the company and from working within two miles of a Jimmy John's store that made more than 10 percent of its revenue from sandwiches, a practice that led to it being sued by the New York Attorney General. This abuse of the non-compete has fueled focus on non-competes across the economic spectrum. In May 2016, the Obama administration, citing research that 18 percent or 30 million workers in the US are covered by non-compete agreements, issued a report titled: "Non-Compete Agreements: Analysis of the Usage, Potential Issues, and State Responses." The report calls for reforms with regards to non-competes and states in part:

> Workers' value comes in part from the skills and experiences gained on the job. Non-competes can reduce workers' ability to use job switching or the threat of job switching to negotiate for better conditions and higher wages, reflecting their value to employers. Furthermore, non-competes could result in unemployment if workers must leave a job and are unable to find a new job that meets the requirements of their non-compete contract.
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> In addition to reducing job mobility and worker bargaining power, non-competes can negatively impact other companies by constricting the labor pool from which to hire. Non-competes may also prevent workers from launching new companies. Some critics also argue that non-competes can actually stifle innovation by reducing the diffusion of skills and ideas between companies. Some critics also argue that non-competes can actually stifle innovation by reducing the diffusion of skills and ideas between companies within a region, which can in turn impact economic growth. Non-compete agreements may also have a detrimental effect on consumer well-being by restricting consumer choice.

The report focused on the overuse of non-competes, particularly among lower wage earners. It found that one sixth of workers earning less than $40,000 are subject to unnecessary non-competes designed to limit mobility as opposed to protecting against disclosure of trade secrets or the protection of key client relationships. The Obama report was characterized as a "call to action" for states to consider banning non-competes for low-wage workers, workers unlikely to possess trade secrets such as restaurant workers, or workers laid-off or fired without cause. It further called for targeting non-competes towards higher executives or R&D personnel likely to have access to trade secrets; giving notice to applicants that they must sign a non-compete prior to their employment and voiding non-competes issued post-acceptance; informing employees of relevant state restrictive covenant law; and the drafting of more reasonable and enforceable agreements.

The Biden administration has also focused on non-competes but has gone one step further. On July 9, 2021, President Biden issued an *Executive Order* called "Promoting Competition in the American Economy." The order, which is prospective, does not ban non-competes but it does "encourage" the Federal Trade Commission (FTC) to "curtail" non-compete agreements. Among the order's other objectives is the facilitation of worker mobility through the promotion of competition and economic growth. While it remains unclear how the FTC will tackle this issue, it will be a year or more before its rule-making process yields new regulations. While it is unlikely that the FTC will eliminate non-competes for the executive and R&D classes, it is foreseeable that the FTC may ban non-competes for most non-exempt employees.

Against the backdrop of the Biden order, there is pending legislation in Congress to regulate non-competes, although its future is an open question. The Workforce Mobility Act of 2021 was introduced in the House and Senate in February 2021. Rather drastically, it proposes to prohibit non-competes in all circumstances except those relating to the sale of business. (S.483) The Freedom to Compete Act was introduced in the Senate in July 2021 and proposes to prohibit non-competes for all employees covered by the FLSA, generally those earning less than $50,000 per year. (S. 2375) Even if these bills, now pending in the Health, Education, Labor and Pension committee, were to pass, which is doubtful, all employees can remain subject to confidentiality, work for hire, and perhaps non-solicitation agreements.

State Legislation

Although there has been activity in over ten states to regulate non-competes, few have banned them entirely. In contrast to current federal policymaking or actions by some states to limit the application of non-competes, other states, believing it to be good for business and economic growth, have passed legislation that *encourages* the enforcement of non-competes.

Examples of legislative activity regarding non-competes is the passage of the Non-Competition Agreement Act in 2018 by the Massachusetts legislature. This law identifies three categories of employees for whom non-competition agreements are disallowed: (1) undergraduate or graduate students in an internship or other short-term employment relationship while enrolled in college or graduate school; (2) employees who are 18 or younger; (3) employees who are classified as non-exempt under the Fair Labor Standards Act (FLSA). However, it does not ban non-competes for other categories of employees and it recognizes that in some circumstances non-competes and other forms of restrictive covenants are warranted.

Similarly, Illinois passed the Freedom to Work Act, effective January 1, 2022, which bans non-competes for employees earning less than $75,000 per year and non-solicitation agreements for those earning less than $45,000 annually. In addition, a non-compete cannot be enforced against an employee when he or she is laid-off due to Covid or similar circumstance unless the employee receives compensation to bridge the gap between their base salary at the time of layoff and the salary earned through subsequent employment. New employees must also be given 14 days to review and sign any proposed non-compete.

On the more extreme end of the spectrum, Washington DC (who we shall give honorary state status for the purpose of this webinar) passed legislation, effective April 2022, that effectively bans employers from requiring employees to sign non-competes.

In contrast, Florida and Georgia, in an effort to make their states more attractive to business, have passed pro-non-compete statutes. In May 2011, Georgia enacted the Restrictive Covenant Act (RCA). The RCA applies to restrictive covenant agreements entered into after May 2011, leaving common law to govern agreements entered into prior to that date. The RCA converted Georgia from a "no-blue pencil" state to one that allows for blue penciling and the modification of an otherwise unenforceable agreement. It further broadened the scope of non-solicitation provisions. Previously, they needed to be narrowly defined to include only those customers with whom the employee had actual contact. Under the RCA, the definition of "material contact" grew to include not only those customers with whom the employee had *actual contact*, but also to those customers: (1) whose dealings with the employer the employee coordinated or supervised; (2) about whom the employee obtained confidential information while employed by the employer; or (3) from which the employee received compensation, commissions, or earnings during the two years prior to the employee's termination. In addition to the broader definition of "material contact," the non-solicitation of customers provision need not expressly define the types of products or services considered to be competitive in order for the non-solicitation provisions to be enforceable. Perhaps to ensure its passage, the RCA does limit non-competes to certain classes of employees, among them sales personal and managers.

Florida enacted § 542.335 which governs the enforceability of non-competes. Effective as of July 1, 1996, it follows the traditional precepts that a non-compete must be reasonable in time, area, line of business, and that a person seeking to enforce a non-compete must plead the existence of the "legitimate business interests justifying the restrictive covenant." It lists five primary types of interests to be protected: trade secrets, valuable confidential information, substantial relationships with customers, patients and goodwill, and extraordinary or specialized training. But the statute also has three provisions that make it unique in the U.S. and decidedly pro-employer. First, it limits the burden of proof for a plaintiff employer, requiring only a prima facie showing that the restraint is *necessary* to protect a legitimate business interest, at which point the burden shifts to the employee to show that the restraint is overbroad or unnecessary (see Fla Stat § 542.335 [1] [c]). If the latter showing is made, the court is *required* to "modify the restraint and grant only the relief reasonably necessary to protect" the employer's legitimate business interests (Fla Stat § 542.335 [1] [c]). In most other jurisdictions, the burden generally only shifts to the employee after the *employer proves* that the agreement is (1) no greater than required to protect the interest at issue; (2) does not impose undue hardship on the employee; (3) and is not injurious to the public. Failure to establish these three elements (depending on jurisdiction) will usually render the agreement unenforceable. Second, it precludes a court from considering "any individualized economic or hardship that might be caused to the person against whom enforcement is sought." Third, it prohibits any rule of contract construction that requires the court to construe a restrictive covenant narrowly against the restraint, or the drafter of the contract.

New York's highest court, its Court of Appeals, perhaps speaking as the Greek chorus for the majority of states, recently categorized the Florida statute as a "foreign law that [is] truly obnoxious." In *Brown & Brown, Inc. v. Johnson*, 2015 Slip Op. 04876 (June 11, 2015, Court of Appeals), Johnson, a New York based employee of a Florida insurance company with a New York subsidiary, signed an employment agreement that included a non-solicitation provision to be governed by Florida law. Johnson was terminated from her employment and began working for a competitor. Her former employer sued, and Johnson defended claiming that the restrictive covenant was overbroad and contrary to New York public policy. The Court of Appeals held that Florida's "nearly-exclusive focus on the employer's interests, prohibition against narrowly construing restrictive covenants, and refusal to consider the harm to the employee," was "offensive to a fundamental public policy of this State" and thus it invalidated the agreement's choice-of-law provision.

Significantly, the court's invalidation of the Brown agreement's choice of law provision did not invalidate the agreement, but only what law governed, resulting in the application of New York law to the plaintiff's breach of contract claim. Additionally, while the court found the agreement's non-solicitation provision to be overbroad as drafted, it denied defendant summary judgement until the establishment of a fuller record to determine if there should be partial enforcement.[1] And, that's the point. Absent political/legislative intervention via statute, courts, sympathetic to the unfairness and destructive impact of unfair competition will enjoin a breach of restrictive covenant when the facts and equities support enforcement. But employers must be able to articulate a strong and cogent argument in favor of enforcement.

Clearly, when drafting non-competes, the law of your state and city should be reviewed and attention should be paid to any pending legislation.

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[1] The *Brown* decision may have resonated with the *Florida Supreme Court who in White v. Mederi Caretenders Visiting Servs. of Southeast Florida,* 226 So. 3d 774, 2017 WL 405,393 (Fla. Sept. 14, 2017) seems to be trying to temper the bias of its own legislature by focusing on the statute's *reasonableness* requirements by acknowledging that an agreement may be "enforceable" as a matter of law, but that it is up the courts to fashion a reasonable remedy and one that can consider the hardship to the employee.

Despite the Current Regulatory Environment, Properly Drafted
Non-Competes Remain an Important and Viable Business Tool

The concern about non-competes and efforts to control the corporate misuse and abuse of non-competes and non-solicits is likely warranted, for they have been wrongly used to interfere with the free flow of labor, disadvantage competitors, and keep wages artificially low. This inappropriate use of restrictive covenants is bad for industry and damages companies' ability to enforce reasonable and necessary non-competes.

That said, it is important to reach above the noise and remember that in 47 states non-competes remain a highly useful and legitimate instrument to maintain an employer's trade secrets, combat misappropriation and unfair competition, and retain key client relationships. Yet, because they are often drafted by counsel who lack cognizance of the law in a given jurisdiction and who use boilerplate "one-size all fits" language that ignores context, non-competes often fail to live up to their promise and at times, *are not* worth the paper they are written on.

Context is key when drafting non-competes. It is important not to overreach and to define a reasonable goal. Do not assume that the agreement will be blue penciled in a way that the employer will find palatable. Litigators have limited time to make their case and credibility before the court is essential. It is easier to argue for enforcement of a thoughtful, narrowly crafted agreement than to defend a patently overbroad non-compete and hope it survives in some modified form. For example, don't draft a non-solicit to preclude contact with all customers, prospective customers, or vendors—that is just punitive. Rather, limit it to those customers with whom the employee was the primary contact, thus making it easier to demonstrate that an important relationship was built at company expense and that the employee has trade secret information about company operations, client needs, customized products, pricing and discounts, buying habits, etc.

It is critical that an employer's non-compete agreements be bespoke and tailored to the specifics of the workplace. Drafters must consider (1) the employee at issue; (2) their role; (3) the trade secret information they may possess; (3) their client relationships; (4) the business interests that need to be protected; and (5) the least amount of protection the company can live with. Last, what is the restriction worth to the company — is it so valuable that the company should consider salary continuation during the limitations period so as to maximize the chances of enforcement? Furthermore, the idea that a company can expect to enforce a 20-year-old non-compete written for an employee who has had multiple jobs over his or her tenure is a mistake. Restrictive covenant agreements should be reviewed and revised periodically to keep them context current.

To put this into context lets focus on the construction industry, an area our firm knows well. Experienced executives, project managers, and estimators in this industry are tough to find and there are many trade secrets that firms want to maintain. Employee rosters of key tradespeople, how they cost out and estimate a job and prepare bids, key vendors, pricing, business know-how, their supplier relationships, prices paid for goods, and sub-contractor relationships and agreements are but a few. While some construction firms are nationwide or global and thus a geographic scope of "any country or state in which the company has operations" may be appropriate for senior executives or project managers, many construction companies are more regional and thus the geographic scope of any non-compete will need to be more limited. What is the goal of the non-compete, employee retention or protecting legitimate trade secrets and relationships?

Thus, a construction firm should consider the following:

1. Who is the employee and what is their title and function?
2. What does the company need to protect?
    a. Business methods
    b. Information about margins, business methods, key subcontractors and related agreements and costs
    c. P & L information
    d. Marketing and corporate business plans
    e. Employee information
    f. Labor relations and side agreements with trade unions
    g. Vendor related information-source, supply times, costs and discounts
3. What is a reasonable restriction time?
4. What is the scope of preclusion needed?
5. What are the chances of enforcement in a given jurisdiction and if challenging should the restriction period be paid or unpaid?

<u>Conclusion</u>

Despite the fact that non-competes have come under scrutiny and increased regulation, they are alive and well. While it is not quite "the more things change, the more they stay the same," it is close. Non-competes are a medium in flux. Careful attention must be paid to current law when drafting a non-compete and they must be used only when the employee has access to trade secrets or has some unique relationships or skills built at the employer's expense. The primary message that businesses should take to heart is that if a non-compete is not drafted narrowly and if the employer cannot, in a one-minute sound-bite, articulate a specific, legitimate protectable interest, the non-compete will likely fail. In this era of heightened scrutiny, it is time for companies to review and, if necessary, revise its restrictive covenant agreements or cancel them if they are not warranted. This investment is essential if a company truly wants to preclude unfair competition, maintain their trade secrets, and secure its client relationships.