

NONCOMPETE AGREEMENTS AND OTHER RESTRICTIVE COVENANTS: A PRIMER AND CHECKLIST

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With the economy in trouble, companies have become increasingly concerned about ways to efficiently and effectively protect their valuable corporate assets, including, in particular, intellectual property and goodwill. As a result, companies have focused more heavily on the development of a comprehensive enforcement mechanism that can be quickly and easily deployed when necessary. Advance planning through properly-crafted noncompete agreements and related restrictive covenants and vigilant monitoring are the cornerstones of a proper enforcement regime.

I. GENERAL PRINCIPLES

Noncompete agreements are agreements that prohibit one par-

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ty from working for a competitor of the other party when the parties' existing relationship ends. Other agreements restricting post-relationship conduct exist as well. These other agreements are frequently also identified as "non-compete agreements," although, more accurately and more generally, they are more properly identified as "restrictive covenants." These other restrictive covenants include, for example, agreements not to solicit customers ("non-solicitation agreements"), agreements not to solicit or hire employees ("anti-piracy agreements" and "no-hire agreements," respectively), agreements not to disclose confidential information ("nondisclosure agreements" or "confidentiality agreements"), and agreements to forfeit something of value if the party competes ("forfeiture for competition agreements").

Typically, noncompete agreements and related restrictive covenants arise in the context of an employment relationship. However, they are also frequently used

in connection with the sale of a business, the purchase of a franchise, partnership and joint venture agreements, independent contractor agreements and settlement agreements.

In most states, noncompete agreements and other restrictive covenants are presumptively enforceable. However, primarily because of the potential implications to the restricted person's ability to earn a living in a chosen field, the circumstances under which they will be enforced are highly fact-intensive and vary from state to state. For example, in California, noncompete agreements will not be enforced if they arise solely in the context of an employment relationship. In contrast, in most other states, non-compete agreements will generally be enforced to the extent they are reasonably necessary to protect legitimate business interests, typically identified as trade secrets, confidential information, goodwill and (in some states) special skills and training. Even then, however, they must be limited in

time, geographic reach and scope, and must also be consonant with the public interest. In addition, states vary on whether and which of the other restrictive covenants are enforceable at all, and if so, whether they are analyzed like noncompete agreements or subject to a less rigorous review.

In states that enforce noncompete agreements and other restrictive covenants, reasonableness is the touchstone of the analysis. The reasonableness of the noncompete involves a balancing of each of the basic requirements (limitation in time, place and scope) in connection with the legitimate business interests to be protected. Each requirement has a bearing on the reasonableness of the others. For example, a shorter duration may permit a broader geographic scope. Likewise, a narrower geographic scope may permit a broader scope of restricted conduct. In addition, the context in which the noncompete arises will affect the analysis of what is reasonable. Specifically, noncompete agreements arising from an employment relationship are scrutinized more carefully than those arising from other transactions or relationships, where the parties' bargaining power tends to be more equal.

When a noncompete is determined to be too broad, states vary as to what happens next. Some states will reform the contract, essentially re-writing it to scale it back to what it should have said in the first place. Other states will "blue pencil" the language, meaning that they will cross out the offending language and read it as if those words had never been written into the agreement. If the contract makes sense with the of-

fending language omitted, it will be enforced; if it does not make sense, it will not be enforced. Other states will simply refuse to enforce the agreement at all.

II. DRAFTING/REVIEWING NONCOMPETE AGREEMENTS AND OTHER RESTRICTIVE COVENANTS

A. Noncompete Agreements

To maximize the likelihood of enforceability, every noncompete agreement should be carefully crafted based on the particular facts and circumstances existing at the time it is written and likely to exist if and when the covenant will be enforced. Doing so requires a thorough understanding of both the interests sought to be protected and the applicable law.

Basic Terms

Every noncompete agreement should address the three essential elements: duration, geographic reach and scope of the prohibited activities. They should also identify the legitimate business interests with sufficient specificity that the restricted party and a reviewing court can balance the need for the restrictions against their burdensomeness. All such provisions should be crafted with an eye toward what would be reasonable.

Additional Issues/Provisions

The issues/provisions below should be considered at the time of drafting and reviewing a noncompete agreement, as they may be necessary for the subsequent enforcement or defense of the noncompete. However, these issues/provisions must be scrutinized with care, as they can not only enhance the enforceability of the noncompete in particular cir-

cumstances, but some may render the entire noncompete void in other circumstances.

- Does the noncompete agreement toll (*i.e.*, does the noncompete period stop running for any reason)? If so, does it toll during the time before the company learns that the restricted party is engaged in proscribed activity? Does it toll before the company is reasonably able to obtain injunctive relief to terminate such competitive activity? While a provision such as this is viewed by some states as necessary to provide the company with the benefit of its bargain (*i.e.*, protections for the full intended duration of the agreement), other states view the provision as rendering the duration too vague and uncertain to be enforceable.
- Does the noncompete agreement proscribe preparing to compete? If not expressly proscribed, it may not be prohibited.
- Does the noncompete agreement permit assignment by, or apply to successors of, the benefited company? If not expressly permitted, the agreement may not be enforceable by assignees or successors. Thus, for example, an agreement without such a provision might not be assignable in an asset purchase agreement. Even with the inclusion of such a provision, however, the new party to the contract may not be permitted to enforce the agreement for equitable reasons.
- Does the noncompete agreement address changes in the

restricted party's role (position and/or job functions) with the company? A provision that acknowledges that the restricted party's role may change over time—and addresses the effect of such changes on the continued viability of the agreement—may save an agreement from being extinguished by the changes.

- Does the noncompete agreement specify the available remedies, including equitable relief and liquidated damages? Specification of such remedies provides clear notice to the court of the parties' intent in this regard.
- Does the noncompete agreement permit fee-shifting (*i.e.*, making one party responsible for the payment of the other party's attorneys' fees)?
- Does the noncompete agreement require a departing employee to disclose his or her new employer and nature of the new position? Such a provision creates an obligation that ordinarily does not otherwise exist. As such, the provision assists the company in enforcing the agreement—either because the company thus timely obtains the relevant information or because the company has an additional argument in court that the departing employee has acted wrongfully in concealing his or her new position.
- Does the noncompete agreement require the restricted party to provide a copy of the noncompete agreement to any potential employer? Such a provision assists in

putting other parties on notice of the company's rights.

- Does the noncompete agreement include a requirement and representation that the restricted party will not take company property or information, will only use the same for company purposes and, upon termination of the relationship (whether an employment relationship or otherwise), will return any such property or information in the restricted party's possession? Such a provision serves as both a legal obligation and a reminder of the obligation to the extent that it already exists under applicable law.
- Does the noncompete agreement provide for continuation of salary and/or benefits during the operative period of the restrictions? Certain types of noncompete agreements (called “garden leave clauses”) provide consideration to the former employee during the restricted period, which may expand the circumstances under which a court will enforce the agreement.
- Does the noncompete agreement include a choice of law provision? Noncompete law varies by state. A choice of law provision maximizes the likelihood that the parties' expectations about what law will govern will be enforced.
- Does the noncompete agreement include a venue/forum selection clause? In the absence of such a provision, disputes concerning the agreement may be brought

in distant or otherwise inconvenient jurisdictions.

- Does the noncompete agreement include an alternative dispute resolution provision (most typically, mediation, binding mediation or arbitration)? Such provisions vary widely, but can result in substantial cost-savings and increased control of the outcome when the agreements need to be enforced.

B. Related Agreements

Although noncompete agreements provide a mechanism to protect a company's goodwill and intellectual property, they can, and should, be supplemented with other agreements. These agreements afford both protections that are not typically part of a pure noncompete agreement and “back-up” protections in the event that the noncompete agreement is not fully enforceable.

Nondisclosure Agreements

Each employee and other person (independent contractor, franchisee, etc.) with access to confidential information should be required to sign a nondisclosure agreement prohibiting the use and disclosure of the company's trade secrets and other confidential information. Agreements like these can be critical to protecting such information. For example, the absence of such restrictions can cause a court to determine that the company has failed to take even the most basic steps necessary to protect its confidential information, and therefore the court will not exercise its extraordinary powers to protect such information.

Invention Assignment Agreements

An employee or other person whose role with the company may cause that person to think of improvements to the company's intellectual property, or to invent intellectual property that would be of use to the company, should be required to sign an invention assignment agreement. Through such an assignment agreement, the company both protects its investment in its intellectual property and gets the full benefits of new developments that arise as a consequence of work for the company.

Non-Solicitation Agreements

Any employee or other person who poses a risk to a company's customers should be required to sign a non-solicitation agreement, *i.e.*, an agreement that prohibits the person from soliciting or accepting business from the company's customers. Like noncompete agreements, nonsolicitation agreements should be narrowly-tailored. However, unlike noncompete agreements, these agreements do not directly implicate an employee's ability to obtain gainful employment.

No-Raiding and No-Hire Agreements

Any employee or other person who poses a risk of taking a company's employees should be required to sign one or both of the following: a no-raiding (or "anti-piracy") agreement, which prohibits the person from poaching the company's employees, or a no-hire agreement, which specifically prevents the hiring—not just solicitation—of such employ-

ees. While such agreements have not been extensively litigated, a no-hire agreement will be less likely to be enforced than a no-raiding agreement, as it imposes a greater restriction than a no-raiding agreement. Nevertheless, both types of agreements are, in many respects, less burdensome than noncompete agreements.

III. ENFORCING AND OPPOSING RESTRICTIVE COVENANTS

Noncompete agreement and other restrictive covenants are typically enforced through preliminary injunctive relief (known by different names in different states). The reason is that if enforcement were delayed until the end of a case, the harm would have already been done. As a result, as a practical matter, cases tend to settle soon after the injunction is granted or denied.

C. Enforcing Restrictive Covenants

The following steps should be taken (or at least considered) in connection with enforcing restrictive covenants. (Some of these steps may not be applicable when, for example, the agreement does not arise out of an employment relationship.)

- Have an established enforcement scheme in place. Long before any enforcement is considered, a so-called "trade secret audit" should be performed to identify the company's intellectual property in need of protection and determine the proper tools (*e.g.*, agreements, notifications, and security measures) that should be in place to protect those assets.

- Conduct an exit interview. Such interviews remind the employee about any post-employment obligations, inform the company's decisions about next steps that may need to be implemented to protect its legitimate business interests and provide ammunition to the lawyers who may be called upon to enforce the company's rights.
- Conduct a review of all computers and servers through which trade secrets and other confidential information may have been taken. Regardless of whether such information is removed entirely from the company's computer or simply copied to an external source (*e.g.*, a hard drive, memory stick, or other removable media), there are typically indications left behind. Finding those indicators without disturbing the evidence necessary for formal proof in a court may, however, require retaining a computer forensics specialist.
- Review the former employee's emails, particularly those leading up to the termination of the employment relationship.
- Send a cease and desist letter advising of the breach (or potential breach) of the restrictive covenant. Such a letter frequently sets the stage for a prompt and satisfactory resolution of the dispute without the need to resort to the court for judicial enforcement.
- Consider whether to file a lawsuit. If the decision is to sue, the lawsuit should be

commenced promptly. Delay can be fatal.

- Determine whether to sue both the former employee and the new employer or only the former employee. Formal involvement of the new employer—whether through litigation or otherwise—raises various issues that need to be carefully analyzed before such a decision is made.

D. Defending Against Restrictive Covenants

The following steps should be taken (or at least considered) in connection with defending against a restrictive covenant. (Like the steps for enforcing a restrictive covenant, some of these steps may not be applicable in all situations.)

- Review all potentially applicable agreements for possible defenses and marshal evidence in support of any potentially-applicable defense.
- Consider in advance how to respond to questions that may be raised during an exit interview and whether to volunteer any information that is not otherwise raised. Of particular relevance, issues to arise will likely include acknowledgment of any applicable agreement, the identity of the new employer, the nature of the new position, and the implications of the applicable restrictive covenants.
- At the earliest possible time—preferably before the new job is accepted—determine how the restrictive covenants will be handled. If appropriate, document the understanding.

Such advance planning and consideration of the former employer's legitimate business interests, if objectively reasonable, will serve not only as indicia that the employee and new employer have acted in good faith, but will provide a court with a framework within which to narrow the scope of any otherwise enforceable restrictions.

- Consider who will pay for the defense costs, and what will happen if a conflict of interest arises between the employee and new employer.
- Consider whether to wait to be sued, or whether to file a preemptive lawsuit.
- Consider potential counter-claims.