

Enforcing (Or Escaping) Covenants Not to Compete¹

The “Great Recession” has brought to the forefront the issue of the enforceability of confidentiality or non-competition agreements, especially in the realm of sales and even more particularly in computer and software services. The most common, but not the only scenario, is employee noncompete agreements. The employer may need to lay off a good employee who has information valuable to a competitor. Even without a layoff, the employee may fear job loss or have suffered a cut in pay or benefits, so may be looking for greener pastures. Actually, the problem can get much worse for the employee. A prospective new employer may not hire an employee who is subject to non-compete; the former employer may not release the employee from the non-compete because it keeps the employee off the market during the non-compete period. This scenario is especially likely where the employee leaves under unfavorable circumstances. Unfortunately, “dirty pool” can be the rule in business.

I. Types of Non-competition Agreements and Where They Are Used.

Non-competition and confidentiality issues also arise in the context of business “partnerships” (by which I mean a business which has two or more owners). Partnerships often do not work out, and not just because of obvious problems of greed, but also due to differences of opinion, values, management style and money earned. A common fallacy of the business startup is the idea that if the owners have the ideas and money to *start* the business then they will each earn enough to make a living. That doesn’t follow: Putting \$100,000.00 into a business does not mean that you can each pull out \$100,000.00 – or even \$50,000.00 – or even anything, for a while. So, often somebody stays and somebody goes. Generally, this problem falls under the rubric of “partnership dispute,” but it often leads to what we at the Law Offices of Donald W. Hudspeth PC call “business divorce.” Business divorce raises many issues, many of them

¹ This chapter is written under Arizona law. Some states, like California, are reputedly more hostile to non-competition agreements. Some, like Illinois, are more liberal – at least in some contexts, like a business sale. So the reader is strongly advised to see a local lawyer for specific advice and **not** to use and apply the general information of this or any other chapter of this book except to ask questions.

similar to a personal divorce. Someone may “act out” by changing locks, seizing bank accounts or customers, etc one of the immediate issues is the right to compete.

Non-competition and the duty of confidentiality can be especially troublesome in the event of business divorce, i.e. where one or more “partners” leave. Not only may the partners (i.e. owners) be subject to a non-competition provision in an employment agreement, LLC Operating Agreement or Buy-Sell Agreement but even if not they are, for as long as the departing members are still owners of the business, they cannot lawfully compete with the business. The reason for this is the “fiduciary duty,” or, at minimum, the duty of loyalty, the business owners owe to each other and to the business. A fiduciary duty is the highest duty imposed at law. It is the same level of duty that a trustee has over the assets and income of a disabled person: that is, the duty of absolute loyalty, honesty, trustworthiness, and integrity. This is one reason why the “buy-sell” agreement is so important. A buy-sell agreement is like a business “pre-nuptial:” It specifies the events, such as divorce, disability, dissociation or death under which the company, or other owners, may or will buy the ownership interests of the departing owners, and sets the price (or formula for determining same) and terms of purchase. This saves a lot of time which would otherwise be spent on arguments and money spent on attorneys’ fees to resolve the issue.

But, non-competition issues in the business divorce setting are beyond the scope of this article except where the departing owner is subject to such “restrictive covenants,” as they are called in a written agreement (again, for example, a confidentiality and non-compete agreement, an employment agreement including same, an operating agreement, or a buy-sell agreement). In this case, again, you have a business on one side and the departing owner or employee on the other. And, we here at the Law Offices of Donald W. Hudspeth PC get questions from both sides of the confidentiality and non-compete issue.²

² There is also the issue of the enforceability of a covenant not to compete related to the sale of a business. Here public policy supports reasonable restrictions on the seller’s right to compete because, arguably, the business purchased would have little or no value were the seller allowed to compete. But still, there is no “blank check” of enforceability.

II. Elements of An Enforceable Non-compete Agreement³

So, in general, what makes a non-competition agreement enforceable? First, we need to deal with a common misunderstanding that non-competition agreements in Arizona are not enforceable at all. This was true, or more true, ten or fifteen years ago when the typical agreement was so badly written that more often than not they were not enforceable. But that is not true now. Today most non-competition or confidentiality agreements that I see are enforceable because they have been drafted by an attorney and because attorneys know that in many states, like Arizona, the court will no longer re-write and enforce a non-compete agreement on weaker terms (the rule under which courts would do this was called the “blue pencil rule”). Instead the court will say “yes or no,” which means that the agreement must be more conservatively written to be enforceable.

To be enforceable in Arizona, and in most states, a non-competition agreement (aka “non-compete”) needs to satisfy three criteria:

A. “Consideration,” i.e. payment of some kind, is given in return for infringing on the employees liberty to work where and how he or she pleases. The best way to do this is to say the agreement is made in return for “good and valuable consideration, which the parties acknowledge to be adequate,” and to attach the Compensation and Benefits as an exhibit to the agreement (or otherwise state the form of payment in the agreement). This way the same agreement, except for the monies and benefits paid, can be used for each employee.

B. It must be ancillary to a broader agreement, e.g. the confidentiality and/or non-competition pledge is related to another agreement. A good way to

³ Strictly speaking, in general, a “non-competition agreement” prohibits not only the solicitation of service but also any contact with and or provision of service to a customer while a “non-solicitation” agreement (or non-competition agreement written as such) prohibits only proactive sales activity. This difference can be important in this high tech age where employees may be allowed to use their personal cell phones and laptops in company business. In that case the employer must have a non-competition agreement, not just a non-solicitation agreement. But the greater the restrictions the more the courts will scrutinize the provisions. As stated above in the general disclaimer all of the articles on this site are intended to be general information. One fact can change the entire analysis. So, “Don’t try this at home,” Have a qualified and experienced *business* attorney review the document. The cost is low and the stakes are high.

do this is to, again, have the “restrictive covenants,” as non-compete and confidentiality agreements are called, be part of the employment agreement. (By “employment” agreement I am including what could be contracts with bona fide independent contractors.). And,

C. Not violate public policy; that is, be reasonable in geographic area and time so that we do not have doctors working at Starbucks because they signed a non-compete. That is an outcome that would violate public policy.

This latter requirement, i.e. reasonableness of time and scope, is where non-competition agreements commonly failed in the past. Businesses would incorrectly assume that if they got the employee or partner to sign the agreement, then it would be enforceable as a signed contract, like most other contracts. But, that assumption was not true in this case because of the strong public policy to protect workers’ right to work, earn a living, and practice the trade for which they are most suited. An educated, trained and skilled worker working in the areas of his or her knowledge and experience benefitted both the worker and society. So, many of the early agreements got thrown in the trash, legally speaking, because they were not reasonable. “Back when” a contract *might prohibit a departing engineer from working in the State of Arizona for ten years*. Today, the same agreement more likely would be drafted to prohibit the departing employee or partner from working in the industry within *ten (10) miles* of the business for a period of *six months to a year*.

III. The Enforceability Pyramid.

The validity and enforceability of the covenant is a function of what the restrictive covenant seeks to prevent. This can be explained by what I called the pyramid of enforceability. At the bottom of the pyramid of enforceability is a blanket prohibition of the employee from working in the industry, e.g. prohibiting a doctor from practicing medicine in a certain area for a certain length of time. Obviously, this prohibition raises public policy issues. It is not good for the doctor or society for the doctor not to be able to practice medicine. We need a careful balancing between the interests of – and potential harm to – the medical clinic where the doctor worked and the harm to the doctor and his or her patients.

First, the consumer, here the patient, has the absolute right to choose and use the doctor of his or her choice. Generally, the patient's rights trump that of the clinic. So, usually, it is not really a question of whether the doctor can see the patient; the doctor can. The question is whether the clinic has an interest in the monies which the doctor earns from that patient. But, as a practical matter, if the doctor cannot earn money from seeing the patient, then he or she probably will not do so.

Right to work: In Arizona, in deciding the issue of the doctor's right to practice medicine (not with old patients, but in general) within the former employer clinic's trade area, the court essentially asked the question "How often does a patient see a doctor?" Six months? Then, it decided that six months was the time period for which the restrictive covenant of practicing medicine in the trade territory would apply. Recovery time, or how long it would take for the business to recover from the loss of the departing partner or employee seems to be another consideration in this right to work analysis. So, beyond the six month recovery period the doctor could practice medicine even in the old trade area.

However, Arizona has a "wrinkle" on the employment restriction. Not only can the employer prohibit the former employee from working in the industry and trade area for some period, which may be up to a year, but also the employer may prohibit the former employee from working for "major competitors". Thus, it is that a major chain store mattress sales person could not work for another major chain mattress seller (defined as doing more than 50% of its business in selling of springs and mattresses) for a while, so would up selling mattresses at Sears.

Confidentiality and Trade Secrecy: The next level up on the pyramid is confidentiality; that is, the enforceability of confidentiality provisions. Confidentiality provisions protect proprietary information of the business, e.g. its clients, what they buy and when, marketing plans, financial performance, etc. This would include intellectual property like patents and inventions, as well as secret formulas, e.g. for Coke.

In this case the public policy presumption shifts to be in favor of the business. In fact, confidential information is protected even without a written contract because there are “trade secret” statutes in every state that protect such information as a matter of state policy. The business may have worked for years to develop its product and clientele and is therefore entitled to the benefits of its labors. In this case as long as the information is truly secret and treated as such (e.g. under lock and key or password protected, etc.) and is not commonly known in the trade (being in the phone book does not equal commonly known as a buyer of product or service X), then the business will have a right to prevent a former owner or employee from distributing such information.

It is not uncommon for agreements to have no time limit on the confidentiality restrictions, but the better rule, and Arizona law, is that there should be some reasonable time limit. Again, it probably depends what it is. A secret formula would probably be protected by patent, and be if protected by patent would be protected for the life of the patent (typically, 20 years); a special process may only be protected as long as it is truly still used and still secret. (Industry has a way of adopting similar processes across the board.) But, in any case, the time period of protection for confidential information can be longer than the restriction against working in the industry. In most circumstances two years would probably not be outrageous.

Non-Solicitation of Clients and Employees. The next and highest level of the pyramid is shared by the restrictive covenant prohibiting the solicitation of clients and employees. Again, public policy supports the business; “inside information” regarding clients is highly protected. For example, there is an old Arizona case in which an insurance representative took client information from his former employer: the types of policies purchased, premiums paid, age and birth dates, time periods and renewal dates, etc. This would be confidential information under the previous level of analysis, but also a breach of the non-solicitation covenant if the agent called on the clients using the old firm’s client list.

Note: In today’s world, technology “upsets the apple cart”. If the employee or partner is allowed to use his or her personal computer or cell phone for

operations then the “non-solicitation” provision may become a moot point. After a partner or agent leaves, clients may call the former partner or agent on his or her cell phone as they have always done, and their accounts are thereby transferred to the agent or partner’s business does on with the new business without breach of any non-solicitation provision. Similarly, if confidential information is on a personal computer or cell phone, the claim to secrecy may be lost. So, as a practice pointer, the business should issue the owners and employees company equipment and have same returned when the person leaves the business. This is still not a perfect solution, but unless the business has at least done this, it may have no chance of bringing a sustainable claim on the grounds of breach of the restrictive covenant.

Remedies: Assuming there is an enforceable restrictive covenant, then what are the remedies available to the business and faced by the ex employee or partner? Generally, the injured party can obtain a temporary restraining order (“TRO”) and preliminary and permanent injunction against the breach. The breach party will face damages equal to the monies earned as a result of the breach, e.g. all monies earned from the wrongfully solicited customer. (Sometimes the damages are specified in advance under what is called a “liquidated damages” clause). Also, there can be claims for (what is called) “tortious interference with contract or business expectancy” which means that the breaching party knowing, intentionally and improperly interfered with an established contract or relationship with a business client or employee in breach of the non-competition agreement.

Note: where a breach of the non-competition or confidentiality provision is shown, a subsequent employer or business can be liable as well. The breach of the non-compete provisions makes the new employer’s act of selling improper for purposes of the tortious interference claim. Punitive damages are awarded on this claim. A related claim is “civil conspiracy,” where the employee and new employer may be liable for the act of making the sale that neither one could do without the help of the other. It is because the subsequent employer or business may face such claims that without the release the departing partner or employee may find him or herself “sitting on the bench” during the non-compete period.

Strictly speaking, the partner or employee should be able to work for new clients (i.e. not with the old firm) and in new areas (i.e. not job description of old job) but these are what I call “arguments, not conclusions.” By this I mean that arguments imply issues and issues imply legal fees and legal fees in any dispute are almost never less than \$10,000.00. And, if the departing partner or employee did actually breach the non-compete, then the damage could be huge. So, because the new business may not want to take the risk, an employee with a 100% winning argument may still “ride the bench” during the term of the restrictive covenants.