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Non-Competition Agreements: Are They Facing Possible Extinction?

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Former employees may be out of sight, but certainly not out of mind. If a former employee of a company is hired by a competitor, the company risks losing more than its trade secrets and confidential information: its goodwill, reputation, and relationships with its customers, clients, and vendors are all at stake. As labour mobility has increased, employers in the United States have increasingly incorporated non-compete agreements into their employment contracts to prevent former employees from trading on the knowledge and relationships created during their employment.

Non-compete agreements implicate the delicate balance between the employee's interest in making a living in his or her chosen field and the employer's interest in protecting their business. Employers, of course, are free to prohibit competition during the course of employment. A post-employment non-compete agreement, however, restricts the ability of an employee to engage in business in competition with the employer for some time after the employment relationship has ended. Such post-employment restrictions are under increasing scrutiny due to concern that they negatively impact job opportunities, innovation and economic growth.

Typically, the enforceability of a non-compete agreement is determined on a case-by-case basis, taking into account factors such as the employer's legitimate business interests, the former employee's ability to earn a living, the duration of the restriction, and the scope of the restriction. In recent years, however, we have observed a growing trend to statutorily limit non-compete agreements or to ban them altogether.

Statutory Prohibitions on Non-Compete Agreements

In recognition of the burden imposed on an employee by a post-employment non-compete agreement—even one that is narrowly defined in duration and geographic scope—and the needs of clients and customers in certain sectors, some states have historically prohibited non-competes for certain professions, including physicians, lawyers, nurses, social workers, and broadcasters. Increasingly, state legislatures are taking action to restrict non-compete agreements. Employers should be aware of this trend and keep up to date on recent legislation. Five states currently prohibit non-compete agreements in most post-employment situations: California, Colorado, Montana, North Dakota, and Oklahoma.[1] In recent years, bills to ban or substantially limit non-compete agreements have been introduced in four additional states: Massachusetts, Minnesota, New Jersey and Virginia.[2]

Existing and proposed laws governing non-compete agreements vary widely in defining their permissible scope. Some take a narrow approach and render non-competes unenforceable only as to individuals who are eligible to unemployment benefits. Some aim to prohibit non-competes only in the employment context. Others are more general in their terms and expand the prohibition to anyone who restrains another from engaging in a lawful profession.
Under current laws and proposed legislation prohibiting non-compete agreements, even "garden leave" arrangements, under which the employer agrees to pay the former employee during the non-compete term, are unenforceable.

Common Carve-Outs

Every state that has enacted or proposed legislation to limit non-compete agreements has recognized that such agreements are desirable in certain situations. The most common carve-outs, which vary by state, include:

- Sale of a business. A seller who sells the goodwill of a business, the

ownership interest in a business entity, or substantially all of the assets of a business may agree not to compete with the buyer within a certain geographic region.

- Dissolution or dissociation of a partnership. Any partner may agree not to compete with other members or former members of the partnership within a certain geographic region.
- Dissolution or sale of limited liability company. Any member may agree not to compete with other members or former members of the limited liability company within a certain geographic region.

For many of these exceptions, the geographic scope of the permissible non-compete agreement is specified by statute and may be limited to the city or county of the business.

Best Practices for Employers

Fortunately for employers, non-compete agreements are not the only way of safeguarding their business interests and competitive viability. Employers can reduce or eliminate their reliance on non-competes by putting into place and enforcing against former employees and independent contractors the following protections:

- Non-solicitation agreements. It is appropriate to require employees to agree not to solicit, directly or indirectly, business from the employer's customers, clients, or vendors after separation. Such agreements should be crafted as appropriate based on the role of the employee. It is likewise appropriate to require employees to agree not to solicit or hire employees of the company. The shorter the duration of the non-solicitation agreement, the more likely it will be enforced.

- Non-disclosure or confidentiality agreements. All employees should be required to sign an agreement that outlines confidential material, knowledge, or information that the employee may not share with third parties. Such provisions can be indefinite in duration.

- The Uniform Trade Secrets Act. Under the UTSA, a former employee can be enjoined from working for a competitor if the former employer can show "actual or threatened misappropriation" of trade secrets. The majority of states have already adopted a version of the UTSA. Others, like Massachusetts, seek to adopt it in tandem with implementation of substantial limits on non-compete agreements.

- Forfeiture-for-competition. Under a forfeiture-for-competition arrangement, a former employee who engages in competition will forfeit benefits or compensation, such as stock awards or severance pay. Unlike a non-compete agreement, a forfeiture-for-competition clause does not per se prohibit former employees from working for competitors. Instead, it incentivises the employee not to compete. A forfeiture-for-competition clause, however, must be contained in the relevant benefit plan document.

Certain states have expressly recognised some of these methods in their legislation or proposed legislation as permissible contracts with employees. As with any restrictive covenant, non-solicitation and non-disclosure agreements should be as narrowly tailored as possible to adequately protect the employer's legitimate business interests without overly burdening the employee.

Conclusion

Although many employers have grown accustomed to relying on non-compete agreements to protect their businesses, efforts to restrict non-compete agreements are expected to continue. Even in the many states that still allow non-compete agreements, employers need to be forward looking when drafting employment contracts, as future legislation may be retroactive and invalidate existing employee non-compete agreements. Putting in place alternative, carefully constructed restrictive covenants is a key step in striking the proper balance between the competing interests of employers and employees both now and in the future.

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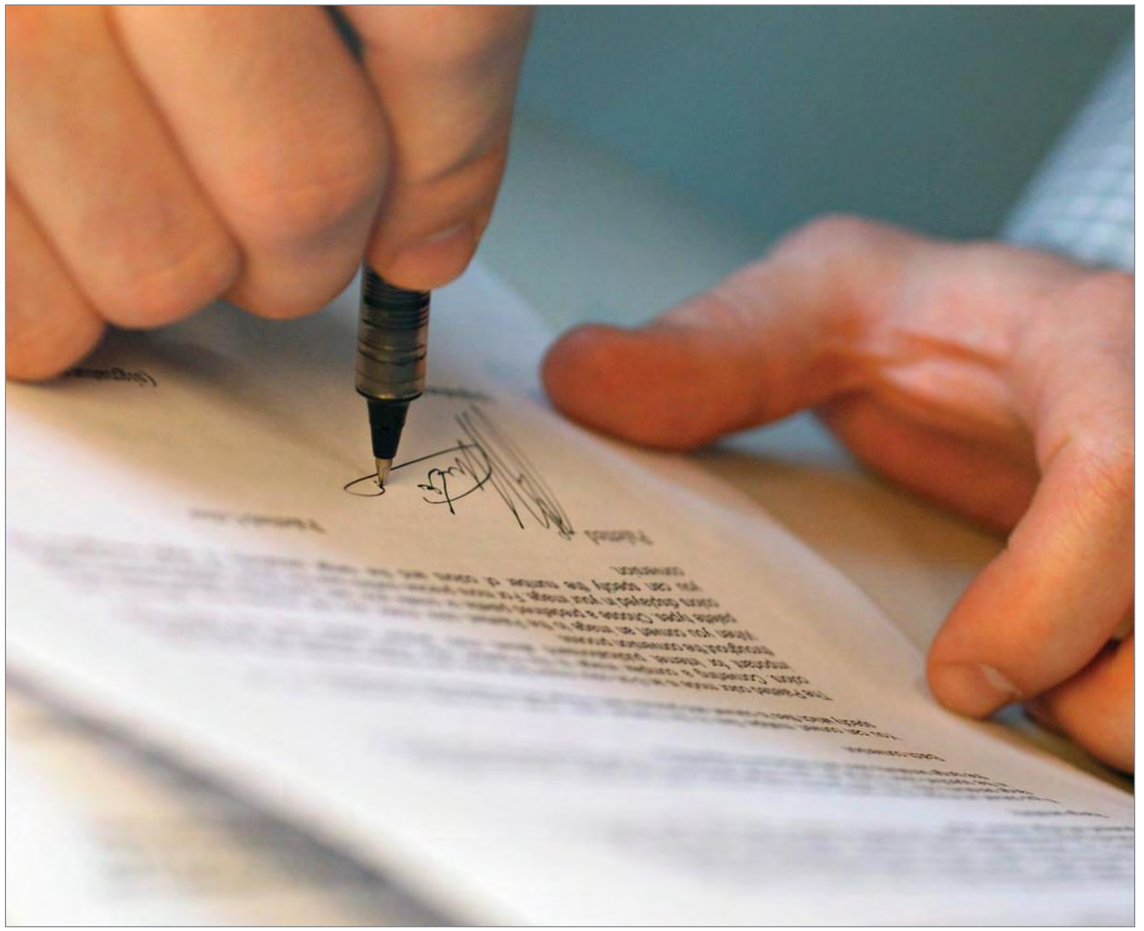

1 - Cal. Bus. & Prof. Code § 16600 et seq.; C.R.S.A. § 8-2-113; M.C.A. § 28-2-703 et seq.; N.D.C.C. § 9-08-06; 15 Okl. St. Ann. § 219A.
2 - Mass. H. 4045 (2014 session); Minn. H.F. 506 (88th legislative session); N.J. Assembly No. 3970 (215th Legislature); VA H.B. 1187 (2012 session).