Practical Tips for Using Restrictive Employment Covenants

Wythe Michael, Maggie Tsai, Kevin Eddins, Evan Slavitt, Kurt Bjorklund and Dan Baxter

For years, employers—especially corporate employers—have commonly included among the terms of employment certain covenants that restrict the ability of the employee to (a) "compete" with the employer upon disaffiliation, or (b) "solicit" other personnel of the employer upon that same disaffiliation. These so-called "non-compete" and "non-solicitation" clauses are particularly common with mid-to-high level employees who pose potential competitive threats not necessarily associated with rank-and-file personnel.

Despite the common and longstanding use of non-compete and non-solicitation clauses by corporate employers, there remains significant jurisdictional balkanization—both within the United States and internationally—as to the validity and enforceability of such clauses. The treatment of non-compete clauses, in particular, varies from jurisdiction to jurisdiction; that spectrum of treatment ranges from "mostly permitted," with some prohibitive exceptions, to "mostly prohibited," with some permissive exceptions.

In this presentation, panelists Wythe Michael, Maggie Tsai, Kevin Eddins, Evan Slavitt, Kurt Bjorklund, and Dan Baxter will discuss the formulation and use of restrictive employment covenants, and the legal treatment accorded to such clauses in the United States and around the world. The session will be broken down into three parts, as follows:

1. A discussion of the practical considerations attending to the use of non-competition clauses, including whether they should be used at all in certain circumstances. Particular attention will be given to avoiding the phenomenon of "non-compete creep," which may have the effect of watering down the non-competition clauses that an employer truly wants or needs to enforce.
2. A comparison of the jurisdictional handling of non-competition covenants (including in regards to the temporal and geographic scope of such covenants), and identification of a continuum of "permissiveness" to "prohibition" along which the various jurisdictions fall.
3. The posing of audience questions/hypotheticals designed to further tease out considerations relevant to the use of non-competition clauses.

At all times during the presentation, audience input will be welcomed, with the overall goal being to achieve a deeper level of understanding regarding the practical use and application of restrictive employment covenants.

Legal Background - Inter-Jurisdictional Treatment of Restrictive Employment Covenants

Kentucky/Indiana Overview – Mostly Permitted

Kevin Eddins

Clients sometimes come into our office expressing the knee-jerk view that non-compete agreements "are not worth the paper they're written on."

This view is understandable in light of the tendency of courts to view such agreements with skepticism. Such restrictions are unfavored under law because they are seen as undermining the public policy in favor of freedom of competition.

Ultimately, however, that view is erroneous. While courts construe such restrictions narrowly, they are in fact enforceable to the extent they are reasonable in scope and necessary to protect an employer's legitimate business interests. Reasonableness is measured with reference to the restriction's temporal, substantive and geographic scope.

Because the tools necessary to enforce non-compete restrictions are equitable in nature, courts will often refuse to enforce such restrictions where employers have unclean hands, including where employers have failed to pay wages owed or provide benefits earned or where they have engaged in harassment or discriminatory behavior with respect to the employee sought to be restrained. Unless resignation results from one of these causes, whether an employee resigns or is fired is usually of little importance in determining whether the restriction will be enforced.

The analysis of reasonableness (as to the time and place of restriction and the activities restricted) is extremely fact-driven. Cases addressing the same agreement between the same parties can have different outcomes given the particular circumstances of each case.

In Indiana and Kentucky, non-competes for mere employees having durations from one to three years have been upheld as reasonable. Non-competes of five years or greater have been upheld where the restrictions have been sought to be imposed on a former shareholder or officer or in conjunction with the sale of a business. In the latter context, what's being bargained for in the sale transaction is the right of a buyer not to have to compete with his seller in the marketplace. Typically, non-solicit restrictions may be of a greater duration since they do not restrict an employee from engaging in his or her chosen trade but restrict competitive activities with respect to existing customer or referral bases as opposed to all potential customers.

The scope of enforceable geographical restrictions vary widely. Nationwide and even worldwide restrictions can be upheld where an industry or product is extremely specialized or a market is truly all-encompassing – albeit usually for shortened timeframes. Courts will consider the specific interests sought to be protected and the type of work performed in determining an acceptable area of restriction. A general dentist with a condensed patient base, for example, might be held to imposing a five-mile restriction on employees, whereas a restriction of four of five times this distance might be upheld for a periodontist (specialist) who draws referrals not from patients but from referring, general dentists across a wider area.

Substantive restrictions should also be tailored based on the particular job duties undertaken by the applicable employee and the nature of the information to which that employee is privy. Post-termination restrictions prohibiting activities the employee did not engage in or contact with customers the employee did not work with while employed with the former employer are very unlikely to be upheld.

A couple of recent decisions have further restricted the enforceability of non-competes in Kentucky and Indiana.

For decades, Kentucky employers were permitted to impose non-compete restrictions on existing employees based merely on employment at will for no particular duration. In 2014, however, the state Supreme Court made clear that continued employment for an indefinite period was insufficient to bind an existing employee to a non-compete. Therefore, for restrictions to apply in Kentucky, they must be signed at the commencement of employment in return for the offer of employment, or they must otherwise be accompanied by additional consideration (including for instance a bonus, a pay increase, or new or enhanced benefits) to existing employees.

Likewise, Indiana courts will now presume that a restriction prohibiting the solicitation of a former employer's former customers (i.e. persons who weren't customers at the time of termination) to be invalid. Former customers are typically ones who had not done business with the employer within a year or two prior to termination.

Unlike in Virginia and some other states, courts in Kentucky and Indiana will apply the "blue pencil" rule, which allows a court to save an agreement which would otherwise be deemed overbroad. In applying the rule, courts may essentially redraw the agreement to narrow the substantive, temporal and/or geographical scope to address only those employer concerns or interests which the courts deem legitimate.

In preparing to impose non-compete restrictions, employers are well-advised to undertake a detailed analysis of the interests they are seeking to protect (those interests which are critical to the business' survival) as well as the scope of restrictions necessary to protect those interests.

Virginia Overview – "Mostly Permitted"

Wythe Michael

Employee non-compete and non-solicitation agreements are enforceable in Virginia if the restrictions are reasonable in scope and necessary to protect an employer's legitimate business interests.

Virginia does not have a statute governing non-competes and non-solicitation agreements. Instead, Virginia courts analyze non-competes based on common law that has developed over many years. Unfortunately, changes in the composition of Virginia's Supreme Court over the years have led to changes in how non-competes have been analyzed. For example, in 2011, the court struck down non-compete language that it had previously upheld in 1989 – only 22 years earlier.

Virginia courts will enforce a non-compete if it is (1) narrowly drawn to protect the employer's legitimate business interest, (2) not unduly burdensome on the employee's ability to earn a living and (3) not against public policy.

The employer bears the burden of proof in establishing reasonableness

Each non-compete agreement is judged based on its own merits including the circumstances of the employee and the business

Over the years, Virginia courts have focused on the following three factors to determine whether a non-compete will be enforced:

- What is the duration of the restriction? Generally a restriction lasting more than 2 years will be deemed unreasonable.

- What is the geographic range of the restriction? The geographic range must closely correspond to the geographic area where the employer actually conducts business.

- What is the scope and extent of the activity being restricted? This factor is often the most difficult part of the analysis. The employer must have a legitimate business interest in prohibiting the type activity restricted. If the type of activity restricted is overly broad, the court will not enforce the non-compete.

Typically courts will analyze all three factors at the same time and give equal weight to each factor.

Virginia has several traps for the unwary:

- The "janitor" defense. Virginia courts will not enforce a non-compete that restricts an employee from working in any capacity for a competitor. To be enforceable the non-

compete must restrict only the type of activity that could harm the employer. For example, Oracle would not be able to prohibit a software salesperson from simply working for SAP since this would also prohibit the salesperson from working for SAP as a janitor, chef, delivery driver, etc. Instead, the restriction can only prohibit the salesperson from working for SAP as a software salesperson or in a role that is otherwise competitive to Oracle.

- No "blue pencil rule." In Virginia, if a court finds that a non-compete is unenforceable, the court will not modify the language to create a reasonable restriction. Instead, the entire non-compete will be thrown out. Therefore, when drafting non-compete agreements, most Virginia lawyers are conservative in drafting the restrictions. It is much safer to err on the side of a more limited non-compete than be in a position of defending a border line non-compete that could be completely disallowed.

California Overview – Mostly Prohibited

Dan Baxter

I. In California, non-compete clauses fall under the auspice of "mostly prohibited."

A. California maintains a strong public policy favoring employee mobility; accordingly, non-compete agreements are generally unenforceable in California.

1. Statutory Codification: Business & Professions Code section 16600: "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."

2. Jurisprudential Reiteration: The effect of Section 16600 is to generally prohibit non-compete agreements, with limited statutory exceptions. See, e.g., Edwards v. Arthur Andersen LLP, 44 Cal.4th 937 (2008).

B. California's jaundiced eye towards non-compete agreements extends to agreements both with employees and independent contractors. See, e.g., Ret. Grp. v. Galante, 176 Cal.App.4th 1226 (2009). Additionally, California courts have even invalidated non-compete clauses between out-of-state companies and their employees when those employees subsequently move to California. See, e.g., Application Group., Inc. v. Hunter Group, Inc., 61 Cal.App.4th 881 (1998).

C. The disfavored status of non-compete clauses in California can produce affirmatively adverse consequences to employers in the form of tort liability for unfair business practices. See, e.g., Robinson v. U-Haul Co. of California, 4 Cal.App.5th 304 (awarding approximately $1,000,000 in compensatory damages and attorneys' fees, and a permanent injunction, against employer trying to enforce non-compete provisions against former employees).

II. California recognizes limited statutory exceptions under which non-compete clauses are permitted.

A. Three primary exceptions:

1. Business & Professions Code section 16601: Non-compete provisions are permitted in conjunction with the sale of a business.

2. Business & Professions Code section 16602: Non-compete provisions are permitted in conjunction with partnership dissolutions/disassociations.

3. Business & Professions Code section 16602.5: Non-compete provisions are permitted in conjunction with the LLC dissolutions/terminations.

B. Importantly, even in the above circumstances, the non-compete restriction must be limited in geographic scope, and may only be enforced so long as the buyer, or person deriving title to the business or its goodwill, carries on "a like business" within the relevant geographic area.

C. Furthermore, courts will closely scrutinize whether transactions subject to the above-listed exceptions place a value on the goodwill interest of the departing owner/partner/member. If no actual valuation of goodwill occurs, the non-compete will likely be deemed invalid. See, e.g., Hill Medical Corp. v. Wycoff, 86 Cal.App.4th 895 (2001); Fillpoint, LLC v. Maas, 208 Cal.App.4th 1170 (2012).

Taiwan/China/Japan Overview

Maggie Tsai

The restrictive employment covenant is a common practice in Taiwan, China and Japan, and its validity depends on whether all the statutory requirements and the principle of fairness and reasons are duly accorded.

To be noted, even though Taiwan, China and Japan are civil law states that promulgate certain laws regarding the restrictive covenant, the principle of fairness and reasons is decisive to the validity and enforceability of the restrictive covenant. It is the shared practice among the courts of Taiwan, China and Japan that, when trying cases involving the post-termination restriction on employees, the courts of these jurisdictions will balance the interests of the employer and employees by taking into consideration the legitimate interests of the employer in IPs, trade secrets, know-how and any other confidential information of values, the strength of restriction on the employees, whether the preceding 2 elements are proportional, and whether any compensation is given in consideration of such restraint of work.

Below please find the criteria for post-termination restrictive covenant in Taiwan, China and Japan:

1. **Taiwan**

   The Labor Standard Act expressly sets forth the criteria for a valid restrictive employment covenant:

   - The employer (which will become former employer for the purpose herein, "**Employer**") has lawful interests in the IP, trade secret, know-how and any other confidential information of value ("**Proprietary Information**").
   - The Employee (which will become former employee for the purpose herein, "**Employee**") has access to the Proprietary Information through his/her duty.
   - The Employee is paid for the restriction covenant.
     (The floor price: 50% of the amount average on the monthly salary for the past 12 months for each month the restriction imposed. The pay may be given in lump sum or in monthly installments.)
   - The restrictive covenant is reduced to writing.
   - The term under restriction is no more than 2 years.
   - The territory for such restriction is no broader than where the Employer engages in business activities at the time of the termination.

   The scope of restrictive covenant-

   Generally speaking, the court articulates whether the Employee conducts the duty he/she serves for the Employer and where he/she serves at a company which conducts business similar to the Employer and in competition with the Employer. Therefore, a restrictive term categorically prohibits the Employer from working in the same industry would be held overbroad and unenforceable.

2. **China**

The Labor Contract Law, along with various rules promulgated by the meeting of judges, has set forth the ground rules for the restrictive covenant as follows:

- The Employee is a high-caliber officer, or otherwise the Employee is subject to confidentiality obligation.
  (Confidentiality obligation can be created by NDA, which is a common practice in the tech industry in China.)
- The Employee is paid for the restrictive covenant.
  (The floor price: 30% of the amount average on the monthly salary for the past 12 months for each month the restriction imposed. However, it is the court's purview to raise or reduce the pay based on the principle of fairness.)
- The term for restriction is no more than 2 years.
- The covenant should specify the territory subject to the restriction, which should be tailored to the territory where any competition with the Employee might occur.

The scope of restrictive covenant

Subject to a valid restrictive covenant, the Employee is prohibited from either of: (1) taking any position in any company which competes with the Employer, or makes or supplies products/service similar to that of the Employer, or (2) starting his/her business that makes or supplies products/service similar to that of the Employer. Such broad scope seems to offer the Employer in China more room to expand the scope of restrictive covenant, such as, categorically constraining the Employee from working for any of its competitors or companies in the same industry, irrespective what duty the Employee would be charged with. However, in light of the principle of fairness and reasons, the court will also adjust or even annuls the terms clearly not proportional to the danger to the Employer's Proprietary Information.

3. **Japan**

Japan promulgates no particular provisions on the restrictive covenant. The validity of such covenant is decided on a case-by-case basis. Below please find some factors the court of Japan would consider in a case over the restrictive covenant:

- Whether the Employer has legal interests in protecting its trade secrets or other confidential information of values.
- The term for the restriction is appropriate. (The court normally considers 2 years term to be sufficient to protect the employer's interest.)
- Whether the territory is aligned with where the Employer conducts business.
- Whether the Employee is paid for the restrictive covenant and whether the Employee has any means to live during the term of covenant.

The scope of restrictive covenant

The court generally rules on the scope of restrictive covenant by assessing whether the new employer to the Employee is in competition with the Employer and whether the Employee serves similar functions for the new employer. In this connection, if the restrictive covenant

simply prohibits the Employee from working in the same industry he/she works at, such clause might be held overbroad and not enforced.