How to Avoid Costly Business Litigation: Tip #6 Use Non-Competition Agreements with Your Employees Sparingly

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AUTHOR'S NOTE: With this article, I am pleased to resume a series I started about 2½ years ago before the pandemic hit. I wrote the first 5 installments of this 10-part series in early 2020, but then the pandemic hit and disrupted business as we knew it. Recently, however, I was flattered to learn that a national publication picked up one of the articles in the series and republished it, which motivated me to complete the series, so here is the 6th article.

Why should you be cautious about having your employees sign non-compete agreements or other restrictive covenants, as we lawyers call them? After all, non-compete agreements have become favored as a means of protecting employers in the business world, as most business owners know from the headlines about lawsuits over restrictive covenants in recent years.

When Non-Compete Agreements Are Appropriate

There are certainly a number of situations where a non-compete agreements is appropriate, even necessary. Say, for example, you are buying a retail business from an entity that has been in that business for many years. The last thing you want is for the seller to start a new company in the same line of business right down the street from you. A well-drafted non-compete clause in the Agreement of Sale can protect you from having to confront that problem. Or, consider that you are entering into an agreement to market and sell a company's products. You certainly do not want the company whose products you will be distributing selling into the same geographic market as you and using the goodwill you created to cut you out of the sales, so it behooves you to include a restrictive covenant in your distribution agreement.

When Non-Compete Agreements Pose Issues

Restrictive covenants in the employment world, however, pose a whole different set of issues. Although courts in most jurisdictions outside of California have been willing to enforce restrictive covenants in employment agreements, the party seeking to enforce the restriction has the burden of proving the restriction is narrowly drafted to protect a legitimate business interest and must overcome the public policy that favors free and open competition, especially in the labor market.

The most extreme expression of that public policy became law a few years ago when the state of California enacted a statute that made most non-compete agreements in employment agreements unenforceable, regardless of the interest sought to protect Commentators predicted that other states would follow suit, but, despite that similar legislation was proposed in several states, that has not happened yet.

Restricting Employees Ability to Earn a Living

Nonetheless, in most jurisdictions, restrictive covenants are more difficult to enforce in employment agreements than they are in business agreements. One reason for this higher threshold is that enforcement of the non-compete could restrict the employee's ability to earn a living. For example, a medical doctor with a narrow specialty located in a geographic region that has a low demand for that specialty might have to uproot her family and relocate to find work if she is subject to a restrictive covenant that prevents her from opening her own practice or working for another firm in that geographic region. In addition, it cannot be ignored that many if not most non-compete agreements are contracts of adhesion, with the employee's only real options being to sign it or be fired. Courts may take such considerations into account as a counterbalance to the employer-friendly language in the employment agreement.

Employees Who Do Not Access to Confidential Business or Trade Secrets

Another problem caused by the over-proliferation of restrictive covenants in employment agreements is that they are frequently imposed on employees who have little or no access or exposure to their employers' trade secrets or confidential business information nor do they hold the employer's goodwill, which are the only legitimate bases for a non-competition agreement. If the employee lacks access to the company's confidential business information, imposing a restrictive covenant on that person can only be viewed as a means to prevent legitimate competition.

An egregious example of this behavior went public a few years ago when it was reported that a woman in New York City tried to enforce a non-competition agreement against her dog walker to prevent him from going to work for another dog owner. Query what was the confidential information sought to be protected in that case? Again, the only legitimate basis for enforcing a restrictive covenant is to protect the employer's legitimate business secrets from being used illicitly by a departing employee to the detriment of the former employer.

Finally, your employees are often your most expensive and most valuable asset. It is one thing to ask members of senior management and certain other key employees who have access to the company's most valuable confidential information and trade secrets to sign a non-compete agreement. It is quite another thing to impose restrictive covenants on rank and file employees, especially when they are existing employees without significant business contacts, not new hires. An employer runs the risk in such cases of sending a message to its loyal employees that it does not trust them. In my experience, you gain more loyalty – and productivity -- from the majority of your employees by paying them fairly and finding ways to let them know that you value their contributions.

Carefully Limit Use of Non-Compete Agreements

In sum, an employer should carefully limit its use of non-competes to those employees for whom one is absolutely necessary. Otherwise, the employer will find itself embroiled in expensive litigation with former employees who will argue, among other things, that their former employer has no legitimate interest to protect and that the public interest will be harmed by enforcement of the non-compete. An employer with an over-reaching non-compete often walks into a courtroom at a disadvantage even if the employer does have a legitimate interest to protect, which is why having an appropriately-tailored restriction is so critical. Moreover, an employer who litigates and loses a case because the restrictions it is seeking to enforce are too

broad faces a risk that other employees with identical non-competes will feel emboldened to violate them. The employer will have the burden to prove that its non-compete deserves to be enforced, which will be expensive. It might be worth the money and the distraction, but, then again, it might not.

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