INSIDE THE MINDS

Negotiating and Drafting Employment Agreements

Leading Lawyers on Defining Key Terms, Reviewing Compensation Provisions, and Constructing Termination Clauses

2011 EDITION

ASPATORE

For customer service inquiries, please e-mail West.customer.service@thomson.com.

If you are interested in purchasing the book this chapter was originally included in, please visit www.west.thomson.com.

Key Strategies for Drafting Enforceable Non-Competition Agreements

Abraham Y. Skoff
Partner; Co-Chair, Litigation Practice
Moses & Singer LLP

ASPATORE

Introduction

An area of increasing focus in both employment law and merger and acquisitions is the protection of trade secrets, confidential and proprietary information, business plans, customer relationships, good will and other intangible assets, and the use of non-competition agreements—sometimes called restrictive covenants—and non-disclosure agreements in protecting these interests. But under the law in virtually every US jurisdiction, non-competition agreements are not automatically enforced. This chapter focuses on key strategies in drafting non-competition agreements which will be enforced.

Consideration in a Non-Competition Agreement

Consideration is one of the key aspects of any agreement, and surprisingly, is sometimes overlooked in the context of employee non-competition and nondisclosure agreements. While some states have unique rules relating to consideration for employee non-competition agreements, in all states, an employer must give some form of consideration to the employee for the non-competition or nondisclosure agreement to be enforceable.

Employers often utilize a stand-alone non-competition/nondisclosure agreement, separate from the employment contract itself. While the employer will often have the employee sign the employment agreement on first joining the company, employers sometimes fail to ask the employee to enter into and execute the non-competition or non-disclosure agreement at the time of hire. If this occurs, there may be an issue as to whether the employer gave adequate consideration for the non-compete or non-disclosure agreement. Therefore, if the employer utilizes a stand-alone non-competition or non-disclosure agreement—which is a strategy adopted by many employers to keep disputes unrelated to the non-compete/non-disclosure from having an impact on the non-compete—the simplest thing to do is to have the employee sign both the employment agreement and the non-compete agreement before the start of employment. In most states in the United States, new employment is regarded as adequate consideration for a non-competition agreement.

Note that, in most (not all) states, an enforceable non-competition agreement also can be entered into after the start of employment, provided

that adequate consideration is given. In some states, the employer must provide specific separate consideration—i.e., a separate amount of money, a promotion, or something else of value—to make the agreement enforceable. However, in most states (not all), continued employment, at least for a period of time, would constitute adequate consideration. Thus, in "continued employment" states, the employer cannot expect to have an enforceable non-compete if the employee is told on Monday, "Sign this or I am going to fire you," and then the employee is fired on Wednesday, after the contract is signed.

Typically, employees who sign non-compete agreements are "at-will" employees; employees often state that, in order to get or keep their job, they had to agree to a non-compete. There have been cases where an existing employee states that, while already working for the company, he/she was asked to sign a non-compete, and did so only to preserve their "at-will" employment, and therefore, did so under pressure and duress. In most (but not all) states, where employment after signing the non-compete continues at least for a period of time, consideration is found to be adequate, and, *assuming that there are no other facts relevant to the issue*, in most states, requiring the employee to enter into a non-compete in these circumstances is not typically found to be legal duress which would result in setting aside the non-compete. Of course, whether the employer has a "legitimate employer interest," whether there is an undue burden on the employee, and, at least in some states, whether the overall treatment of the employee was fair, are always issues in the enforcement of a non-competition agreement.

Identifying the Need for a Non-Competition Agreement

The first step in drafting a non-competition agreement involves identifying the reasons why such an agreement is needed, the nature of the business and assets which the employer seeks to protect, the potential harm that could be done in the absence of such an agreement by the employee or category of employees at issue. In most states, in order to enforce a non-competition agreement, the employer will need to identify to the court its legitimate interest for enforcement of the non-competition agreement. Most states recognize as legitimate interests the protection of trade secrets and confidential information, the protection of goodwill and customer relationships, and some other interests. New York State law also cites the

need for protection from competition from a unique employee, although there has been some litigation over exactly what that means. Identifying at the outset the business, assets, and interests sought to be protected can facilitate the definition of the legitimate interests that will later need to be identified to a court, and should also assist counsel in defining restraints in the agreement that are geared to protecting the interests at issue.

A company's officers or managers may come to counsel and say, "We are hiring this terrific employee: we are lucky to have him or her, and we are paying the employee a lot of money because we want to make sure he or she stays with us forever. We consider the employee to be a franchise player—as long as he or she is on our team, we are going to get tons of business. But the employee is so good, we're afraid our customers will go with the employee if he or she leaves. So draft a very strict non-compete that will prevent the employee from ever leaving and competing against us."

The law does not recognize an employer's right to discourage the mobility of its employees. In fact, the law generally provides that employees are allowed to move from job to job in order to better their situation. And the law does not permit the use of non-competition agreements merely to decrease or limit fair competition. Rather, the law in most states requires that, to be enforceable, the non-competition agreement must be no greater than is required for the protection of the legitimate interest of the employer, not impose undue hardship on the employee, and not be injurious to the public. *See BDO Seidman v. Hirshberg*, 93 N.Y.2d 382 (1999), *citing Technical Aid Corp. v Allen*, 134 NH 1, 591 A2d 262 (1991), *Reed, Roberts Assocs. v Strauman*, 40 NY2d 303, 307 (1976) (non-competition agreements will be specifically enforced only where;…reasonable in time and area, necessary to protect the employer's legitimate interests, not harmful to the general public and not unreasonably burdensome to the employee." *See Solari Industries v. Malady*, 55 N.J. 571, 576 (1970); *Whitmeyer Bros. Inc. v. Doyle*, 58 N.J. 25, 32 (1971).

The "legitimate employer interests" that the law recognizes are akin to property interests; protection of these interests is seen as needed to prevent unfair competition by the departing employee. Typically, and in most states, (i) an employer may protect its confidential and proprietary information, its trade secrets, and its secret know-how; departing employees who are subject

to enforceable non-competes and/or non-disclosure agreements may not take this information and use it for another company; (ii) the employer may protect its goodwill and customer relationships; an employee who is subject to an enforceable non-compete agreement may not use these relationships and goodwill to compete with the former employer. Some states recognize other interests as worthy of protection, such as the employer's interest in specialized training that was provided to the employee or preventing unique forms of competition.

Based on the foregoing, one key principle to keep in mind when drafting a non-competition agreement is that as good as it may feel to the client to draft a super-strict non-competition agreement, the point of the agreement is to have an agreement that can be enforced if need be and where the threat of enforcement is a real concern. If you did not draw up the agreement properly, you are not going to have an enforceable interest, and the court will not help you. Therefore, it behooves the drafter to draft an appropriate non-competition agreement that is enforceable and will protect your interests, rather than one that is "super-strict" and may not be enforceable. Of course, there are employees, such as the leading executives of a company, or those who are otherwise so involved in all aspects of the company's business and/or whose knowledge and involvement are so significant, or whose knowledge of critical information is such, that a very broad non-compete might be justified. And there are some states where broad non-competes are enforced in appropriate circumstances. All of these factors must be considered by counsel during the drafting process.

Enforceability of Non-Compete Agreements

How does one deal with the "franchise player" employee? How can counsel address the concerns of management in drafting a non-compete for the "star" employee? When drafting a non-competition agreement for an employee that the client regards as a "franchise player," it is important and appropriate to recognize that this individual is expected to be deeply involved in dealing with customers and in the employer's goodwill and relationships with the customers. Since protection of goodwill with customers is typically an interest that the court will recognize and use as a basis for enforcing non-competition agreements, a reasonable restriction designed to protect this interest would likely be enforced (assuming

consideration and other applicable factors). By drafting restrictions geared to these interests, counsel can obtain protection for the client in an enforceable non-compete.

If the key employee is "key" for a reason other than customer involvement, identify the reason and draft the non-competition agreement based on the interests that need to be protected. For example, in most states, courts will protect an employer's confidential information. If a newly-hired employee will be heavily involved with that type of information, that is another interest that a court will likely protect by enforcing a properly drafted non-compete agreement.

If the only interest the client is concerned about is the fear that customers are going to follow an employee to her new company because she is so good at what she does, you may not have a basis to enforce a non-competition agreement. Any employee is entitled to maximize his or her effectiveness, and competitors are entitled to try to hire the best employees they possibly can.

But almost always, that "franchise player" will be involved in the protectable "legitimate employer interests." If the employer drafts a non-competition agreement that addresses its legitimate interests, and drafts the reasonable restrictions that actually protect those interests—rather than drafting a catchall that attempts to restrict every possible activity—the employer should be able to get the protection it needs. If that "franchise player" goes to another company and tries to interfere with goodwill and relationships with customers, or to use inside information, these interests can be protected.

Therefore, to be able to enforce the non-competition agreement when the time comes 1) identify what they are trying to accomplish; 2) identify and determine what the law is in the state where the employee is going to work, where the company is headquartered, where the employee will enter into the contract, and where the impact of the employee's work will be felt; and 3) make sure that the restrictions are drafted reasonably to restrict that which is protectable. Using the previous example, in typical circumstances, a non-competition agreement will not be valid simply to tie up a "franchise player," but should be quite effective in protecting the company from the

"franchise player" misusing the company's confidential information, customer relationships, and goodwill and, in New York, from competition from a "unique employee."

Mistakes to Avoid in Creating an Effective Non-Compete Agreement

Avoiding a non-competition agreement that is unenforceable is not only a function of the activities restricted, but also of the geographic, temporal, and/or customer restrictions. Overly restrictive non-compete agreements are always subject to attack.

Let's say that an employer client wants a non-compete agreement for an employee who is only going to be working in certain states, but wants the employee to enter into a non-compete agreement that covers the entire United States. Unless the employee is dealing with confidential information, goodwill, customers, or other protectable assets that pertain to the entire United States, an agreement that pertains to the entire United States would likely be a mistake, because such an agreement would be overly broad. If, for example, the client does not do business in California, Wyoming, or Oregon, the agreement would be overly restricted if it pertained to the areas in which the client does not do business—unless the non-compete is needed to prevent use of the client's assets even in those states. In fact, if you try to enforce such an overbroad contract, the court may say, "You were overreaching here—you had much more bargaining power than the employee, and you imposed restrictions on the employee that were too onerous." Depending on the state and the rest of the circumstances, this may lead to a decision by the court to decline to blue line the contract—to decline to modify the agreement to make it enforceable.

Geography isn't the only aspect in which agreement terms can be overly broad. For instance, let us say that the client's superstar employee has a deep involvement and understanding in the market and customers in Chicago, but is not otherwise involved in administrative matters or in the company's other markets. Under the law in most states, you would not want to create a non-compete that restricts such an employee from working in an administrative capacity, or that does not involve sales or customer relationships in a sales market in Texas, unless those positions would permit the employee to improperly draw upon the confidential information and

relationships of the company that are entitled to protection. Similarly, if an employee is not involved in technical issues or design, and does not even have access to the company's confidential information related to technical issues and design, drafting a restriction on this employee that is based on protecting information that this employee does not have access to could well be regarded by a court as overly broad. When it comes time to have the employee's contract enforced, the judge will want to know why the agreement was drafted to restrain that which the employee had no access to. Judges typically regard employers as having more bargaining power than employees, and as being in a position to demand certain terms—indeed, in most cases, employees don't negotiate non-compete terms—and therefore look closely at the breadth of non-compete provisions.

The overall reasonableness of the agreement is typically an issue that a court will consider in determining whether to enforce a non-compete. Therefore, counsel should draft to make sure that the client's interests are protected in an agreement that is reasonable in the circumstances.

Acquisition Issues in Drafting Non-Competition Agreements

In some cases, counsel is called upon to draft non-competition agreements in the context of an acquisition or merger, in which the acquiring company will have both an acquisition agreement with the sellers, and will also be employing people who worked for the acquired company. Some of the new employees may be the sellers of the acquired company. A non-competition agreement with a selling owner is very different from the hiring of an employee, and the courts typically view this situation as one in which the seller is doing an arm's length transaction with the acquirer. As a result, courts will typically enforce the non-compete agreement with the selling owner, although in some states a party seeking enforcement must still show that the restrictions are reasonable.

Selling owners who go to work for the acquirer typically end up being party to both an acquisition agreement and an employment agreement. When a non-compete is signed in the context of the sale of one's interest in a business, the courts typically make two assumptions: 1) that it is an arm's-length transaction in which both parties have bargaining power; and 2) the seller sold their goodwill in the business, and it would not be fair to the

buyer if the seller could then go out and compete against the buyer and try to take all of the company's customers. As a result, courts are likely to enforce restrictions imposed as part of the sale of a business.

Indeed, under the law in most states—including in such high-profile states as California—in connection with the sale of one's interest in a business, the courts will likely enforce a non-compete agreement without doing the type of detailed, careful, and heavily scrutinized review of each provision in order to make sure that it is fair. Simply put, this is a very different legal situation as compared to evaluating a non-compete agreement with an individual employee.

Here, too, a few states apply a greater level of scrutiny, even in an acquisition context. As counsel, you need to know the law of the state where the acquisition takes place and where enforcement is likely to be sought.

In addition, where the selling owner has two agreements—one an acquisition agreement and the other an employment agreement—there can be issues as to which standard of review applies to the employment agreement. This really requires a case-by-case analysis, and it is difficult to generalize, although seller-employees are often regarded more as sellers than employees, unless the circumstances require a different conclusion.

Customizing and Standardizing Non-Compete Agreements

Many companies have programs where all employees are asked to sign non-compete agreements, or all employees above a certain level must sign non-compete agreements. When the company has a large staff, the employer is sometimes reluctant to customize the non-competes to fit particular situations or employees. But in the non-compete world, one size does not usually fit all. For example, a non-compete that a court will enforce in connection with a salesperson who is going to be involved in customer relationships, and who may know some confidential customer information, is going to be a very different agreement from a non-compete that you will need for a senior executive who is privy to all of the confidential information in the company; it is also going to be different from a non-compete agreement that you are going to need for somebody who is developing cutting-edge IT applications on behalf of your company.

A client may say, "I am running a business here—I am not running a contract factory; and I cannot take the time to customize 1,400 non-competes."

That is true, but what you *can* do—what is more likely to best protect the company's interests—is develop several templates for non-competition agreements, because employees tend to fit into certain categories. For example, of those 1,400 employees, 400 may be salespeople. You can develop a non-compete template for the sales force. Likewise, one hundred employees may be product developers, and you can develop a somewhat different non-compete template for these employees. Fifty key employees may belong to senior management, and you certainly should develop a non-compete template for senior staff.

Therefore, to best serve the client's needs, you don't need a contract factory, but you may need three or four templates. You can tell the client, "you do not have to negotiate a separate form for each of your 1,400 people, but given your company and its different employment categories, you should have three or four templates, and you should also have some sub-criteria that allows you to customize those templates to some extent, depending on the circumstances." Again, it is a good idea to remind the client that they will fare better in court if they have agreements geared to the categories of employees, which include the restrictions that apply to a particular category. I have seen cases where an employer had everyone in the company sign the same non-compete, and then tried to enforce that form against employees who did not have any access to customers, confidential information, etc. This approach can undermine the client's position, as well as their credibility with the court, and thus hurt the effort where protection is needed.

Similarly, even where a client has employees in many different states, it is generally possible to prepare a template which, for each category of employee, can be customized and used in that state. Choice of law provisions may also be used in appropriate circumstances.

Trade Secret Protection Considerations

In the current "information age," protecting a company's information is critical. In order to protect information that is regarded as both confidential

and necessary for a business to succeed, an employer needs to have a trade secret protection plan that consists of elements such as protecting access to the information, making sure that the company has non-disclosure agreements with the people who have access to confidential information, and making sure that confidential information is treated as confidential within the company and is not just freely handed out or made available to everyone. It is important to ensure that the company has policies in place so that everyone understands who an employee is allowed to share information with, what types of information one is allowed to disclose to third parties, and how information is to be protected, accessed, and handled, etc. As part of a trade secret protection program, a client would want to have both non-disclosure agreements and non-competition agreements for those employees who will have access to trade secret information, and who, if they left and went to work for certain types of employers, might necessarily end up using the company's confidential information in a manner that would be detrimental to the client.

Therefore, when counsel is asked to draft a non-competition agreement for a client's new hire, it is important to ask the client for information about what the new hire is going to be doing and what information this person has access to. The client may say that this employee will have access to the detailed price breakdown of every product sold, and will also have access to every account file of every customer the company has, and therefore will know about every item that every customer has ever ordered from the client and what they paid. Your next question to the client might be, "Okay, who else in the company has access to that information?" The client may say that everyone in the company has access to that information.

You should then ask if the other employees have non-compete agreements, and if the client says, "No, I never asked anyone else to sign one," the natural follow-up question is, "Why is this person different—and who other than your employees has access to this information?" The client may say, "We are a customer-friendly company, and one of our big selling points is that any customer can access our website and find out the specifications and cost breakdown of every one of our products." In other words, in this instance, just about everyone in the world can get access to at least some of the information that the client now wants to protect by having this new employee sign a non-compete.

In such a case, counsel needs to confer with the client to consider such things as whether there are subcategories of information that "the whole world" does not have access to and that need to be protected; whether the client wants to change its policy concerning who has access to certain information; and whether additional agreements or policy statements are necessary to protect information that certain people (but not everyone) are permitted access to, etc. Thus, a key point in identifying the relevant confidential information is understanding the client's overall situation with respect to the protection of key information. Even if this review results in the conclusion that certain information that the client wants to protect is already public, you may be able to help the client very significantly by getting the client to recognize that steps within the organization are needed to protect this type of information, so that the next time the client hires someone they can have that person sign a meaningful non-disclosure or other agreement that is actually going to protect them.

Final Thoughts

To draft an enforceable non-competition agreement, identify the purposes for which the client wants the non-competition agreement, identify the restrictions needed to accomplish these purposes, and understand the law of the relevant state—what is enforceable in that state and what is not. Then draft accordingly. When you draft the agreement, ask yourself, "In what circumstances will I try to get this agreement enforced, and what I am going to argue in order to get it enforced?" You should not get caught up in the desire to have the most onerous agreement possible; it must be an agreement that a court will likely enforce. Therefore, counsel needs to identify the client's legitimate business interests, and make sure the agreement covers those interests, but does not extend into other areas where a court would not enforce it. In fact, if the agreement is overly board, it might actually jeopardize the enforcement of the employer's legitimate interests.

And don't forget consideration. If the client is having an employee sign a stand-alone non-compete agreement that is not part and parcel of the employment agreement—which is preferable in many respects—you need to make sure that there is consideration for the non-compete agreement. Depending on the law of the relevant state, consideration can be the hiring

of the employee, money paid to (at least in most states), continued employment, at least for a period of time, or the promotion of an existing employee. In some states, consideration may also be specialized training or access to confidential information. But some states have unique rules on consideration, and these must be reviewed.

Finally, when you draft a non-competition agreement, you need to obtain an understanding of the client's overall situation with respect to customer relations, the protection of trade secrets, and other matters, and if you see that the client needs to take some action in order to clean up their processes, make suggestions accordingly.

Key Takeaways

- The first step in drafting a non-competition agreement involves working with the client to identify the reasons why the client needs such an agreement. In order to enforce a non-competition agreement in most states, the employer will need to identify their legitimate business interest for requiring the non-competition agreement—e.g., the protection of trade secrets or confidential information. Similarly, most states recognize the importance of protection of goodwill and customer relationships. If you are having an employee enter into a stand-alone non-compete agreement that is not part and parcel of the employment agreement—which is preferable in many respects—you need to make sure that there is separate consideration for the non-compete agreement.
- If a client asks you as counsel to create a very onerous and highly restrictive non-compete agreement, you have to explain that such an agreement could likely be held to be unenforceable. The task under the law is to create a very strong agreement, but one that is capable of being enforced. Simply stated, counsel's job is to figure out what the client's recognized legal needs are, and to draft the agreement that is likely to be enforced—which is often an agreement that is not the most restrictive on paper, but that accomplishes the protection of real legitimate interests. A non-competition agreement should restrict the employee's interests to the extent necessary to protect the employer's interests.

- It is usually possible to develop templates for the non-competition agreements that will be suitable for different types of employees and for employees in different states. One size may not fit all, but several customizable templates will typically cover all but certain unique employees.
- Even if you find that in a particular situation you cannot use a non-compete or non-disclosure agreement to protect certain information that is already public, you may be able to help the client by getting the client to recognize that they need to take steps within their company to protect their information and goodwill.

Abraham Y. Skoff is co-chair of the Litigation practice at New York's Moses & Singer LLP, chair of the Business Torts/Unfair Competition practice, and co-chair of the Employment and Labor practice. Mr. Skoff has more than twenty-five years' experience in practicing law, including involvement in a number of major newsworthy cases. He served as assistant US attorney and deputy chief of the Civil Division, US Attorney's Office, Eastern District of New York. Mr. Skoff has litigated cases in courts throughout the country, and focuses his practice in the areas of complex civil and commercial litigation, corporate and business torts, injunctive proceedings, litigation of unfair competition, entertainment, trade secret, employment, restrictive covenant, health care, commercial, product liability/toxic tort and insurance matters, health care transactions, and government investigations. Mr. Skoff is an experienced trial lawyer. He has represented parties before the judicial panel on multi-district litigation and has coordinated the defense of nationwide class action claims. Mr. Skoff is admitted to practice in New York and New Jersey, and practices actively in both states.

Mr. Skoff is rated "AV" by Martindale-Hubbell and has been listed in New York Super Lawyers® *from 2006 to 2010 by the publishers of* Law & Politics *magazine. In a recent case, he was co-counsel to a corporate defendant accused of trade secret misappropriation in connection with the hiring of a new employee. The client denied plaintiffs' claims, asserted an abuse of process counterclaim, and, after extensive litigation, obtained a multi-million dollar verdict on its counterclaim.*

In the health care area, Mr. Skoff engages in both transactional matters and litigation. He has represented business entities, health care organizations and individual providers in the structuring and documentation of managed care, disease management and other agreements. As well as in practice and partnership arrangements, in the litigation and

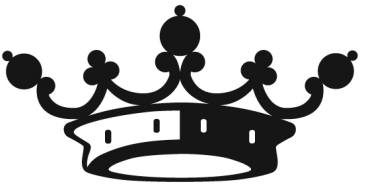
arbitration of health care, insurance and reinsurance related matters, and in disciplinary proceedings, licensure and credentialing disputes.

Mr. Skoff received his JD from New York University School of Law and his AB from Columbia College.

ASPATORE

Aspatore Books, a Thomson Reuters business, exclusively publishes C-Level executives and partners from the world's most respected companies and law firms. Each publication provides professionals of all levels with proven business and legal intelligence from industry insiders—direct and unfiltered insight from those who know it best. Aspatore Books is committed to publishing an innovative line of business and legal titles that lay forth principles and offer insights that can have a direct financial impact on the reader's business objectives.

Each chapter in the *Inside the Minds* series offers thought leadership and expert analysis on an industry, profession, or topic, providing a future-oriented perspective and proven strategies for success. Each author has been selected based on their experience and C-Level standing within the business and legal communities. *Inside the Minds* was conceived to give a first-hand look into the leading minds of top business executives and lawyers worldwide, presenting an unprecedented collection of views on various industries and professions.



ASPATORE

MOSES & SINGER LLP

Disclaimer

Viewing this or contacting Moses & Singer LLP does not create an attorney-client relationship.

This is intended as a general comment on certain developments in the law. It does not contain a complete legal analysis or constitute an opinion of Moses & Singer LLP or any member of the firm on the legal issues herein described. This contains information that may be modified or rendered incorrect by future legislative or judicial developments. It is recommended that readers not rely on this general guide in structuring or analyzing individual transactions or matters but that professional advice be sought in connection with any such transaction or matter.

Attorney Advertising

It is possible that under the laws, rules or regulations of certain jurisdictions, this may be construed as an advertisement or solicitation.