

You Can Protect Your Business with Restrictive Covenants such as Non-Compete Agreements

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A company which has been around for awhile has made an enormous investment in time and money building its business. When it hires an employee to market its services, the last thing it wants is to introduce the employee to its customers and referral sources, only to have the employee leave and take the business with him/her. That is why many companies include covenants not to compete ("restrictive covenants") in their employment agreements with employees. Typically, these covenants prohibit the employee from practicing in a certain geographic area for a certain period of time following termination of employment. The covenant may also anticipate the employee's departure by providing for "liquidated" damages, which are a predetermined amount of damages to be paid by the employee if the employee breaches the covenant. When the employee leaves the employer, stays in the community, takes the business, and challenges the enforceability of the covenant, the courts apply certain rules to determine whether the employee will be able to "stay and play," or "pay to play," or "get out of Dodge by sundown."

Contract Rules

The first thing to know is the contract rules. With one rare exception, a covenant not to compete should be in writing. A covenant not to compete must be connected to another valid contract. The other valid contract for an employee is the employment agreement. The employment agreement can be oral or written. It can be for a set period of time or "at will." The employer must give the employee something for the covenant - something called "consideration." That's the promise, or the benefit or the detriment, underlying the contract. Typically, the employer gives the employee "employment." The employee gets the job and the employer gets the restrictive covenant. The job is "consideration" for the restrictive covenant. If the employee is already working for the employer, and the employer decides it wants a covenant, the best thing to do is to give the employee something new for the covenant - something other than merely letting the employee keep his/her job. The courts call this "new consideration." It could be a change in job title, a bonus, an extra day of vacation, or anything else that would be a benefit to the employee.

Consideration is the first contract rule employers should worry about. Another is the clarity of the contract. Does it mean exactly what the employer thinks it means, or could it be interpreted in some way that would let the employee off the hook? Another contract rule involves inconsistent conduct by the employer after the contract is signed. If the employer tells the employee to sign the covenant, but not to worry because the employer will never enforce it, the courts may conclude the employer gave up the right to enforce the covenant. If the employer doesn't enforce the covenant against employee A, but chooses to enforce it against employee B, the courts may conclude the employer gave up the right to enforce the covenant. If the employer starts unilaterally changing the terms of the covenant, either through administrative, director, shareholder, or other owner conduct, the courts may say the employer gave up the right to enforce the covenant. If the employer waits for six months after the employee leaves and starts competing, the courts may say the employer gave up the right to enforce the covenant. If the employer breaches the employment agreement in a way that goes to the heart of the relationship with the employee, and to the heart of the reason for the covenant, then the courts may decide the employer gave up the right to enforce the covenant.

The contract rules are important, but at the end of the day they do not tell you whether the restrictive covenant will be enforced. Because the covenant limits competition, it's called a "restraint of trade," and it has to survive the application of four more rules. **The covenant must serve a legitimate business interest, be reasonable in its time and territory restrictions (and its liquidated damages if present), not cause an undue burden to the employee, and not cause substantial harm to the public welfare.**

Protecting the time and money invested in building the business is a "legitimate" purpose of a restrictive covenant. An "illegitimate" purpose is to avoid ordinary competition, which is the kind of competition a stranger could give the employer. For example, if an employer employs someone with an

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established book of business, and doesn't give new consideration for the book of business, six months later the employee can probably leave with the same book of business he/she came with, even if the employee signed a restrictive covenant. The employer has not shared its investment - its trade secrets, training, or customer, patient or referral relationships - with the employee. The employee already had those things, and can keep those things when he/she leaves. Otherwise, the employer is trying to avoid "ordinary" competition, the kind of competition the employee was giving the employer prior to getting hired.

Reasonableness of restrictions.

The time and territory restrictions must be narrowly drawn to protect the legitimate interest of the employer. If the service area of the employer is 25 miles, a restriction of 100 miles is unreasonable and will not be enforced. By the same token, if the employer only needs 2 years to hire a replacement and to reestablish its relationships with its customers or referral sources, a restriction of 5 years will not be enforced.

Undue burden on the employee.

Whether a covenant not to compete creates an undue burden on the employee is pretty much in the eye of the beholder. Most courts will enforce a restrictive covenant if the employee can find a similar position in some other geographic area without much difficulty. One should not underestimate the emotional pull, however, of throwing an employee out of a community when the community just happens to be the place where the employee grew up and is raising his/her children.

Public welfare.

The courts have, over the years, carved out an exception to enforcing restrictive covenants for public welfare services such as in the health care industry. If an employee provides services in a medically necessary specialty, then the courts will take a hard look at the community need for that specialty, and will not enforce the covenant if to do so would leave the community without that specialty, or with a critical shortage in that specialty. The court must decide two questions. First, what is a medically necessary specialty, and, second, what is a critical shortage.

A liquidated damages clause may solve the problem of protecting the employer's business when it comes to critical care specialties. If the courts can allow the specialist to continue practicing but require him/her to pay the employer for the employer's loss of investment, then both the interest of the employer and the public are served.

Conclusion.

If the employer meets the contract and restraint of trade rules, then the covenant not to compete is enforceable. The covenant may be enforced through getting an injunction to prevent the employee from practicing in the restricted area for the restricted time. Or the covenant may be enforced through the award of damages - either liquidated (agreed to in advance) or not.

For Further Information

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