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Noncompetes: How Employers Can Protect Their Business Interests

Employment and Labor

Cheat Sheet

- **Wage suppression.** Critics of noncompetes, such as US President Biden, say they hold back employees from earning their full potential.
- **Business protection.** Employers with legitimate concerns should shore up agreements as soon as possible.
- **Alternative arrangements.** There are myriad types of agreements, such as forfeiture-for-competition, non-solicitation, "bad boy" provisions, and garden leave, that may meet the business need in lieu of or in addition to a noncompete.
- **Legal landscape.** Understanding what's permitted in each jurisdiction will help with enforceability.

Following through on a campaign promise on July 9, 2021, President Biden issued an Executive Order titled “Promoting Competition in the American Economy” (the Order). Among a number of other actions and recommendations, the Order encourages the Federal Trade Commission (FTC) to adopt rules banning or limiting the use of non-competition agreements.

For employers that rely on non-competition agreements to protect their legitimate business interests, especially those that rely heavily on proprietary information and trade secrets to compete in the marketplace, concern is continuing to mount about how to move forward in a legal landscape that limits or bans an important tool for employers.

This action was not at all unexpected. President Biden has been a longtime opponent to non-competition agreements. In 2016, then-Vice President Joe Biden urged the elimination of noncompetes, explaining his belief that workers could not reach their full and true potential without the freedom to negotiate for a higher wage with a new company, or to find another job after they've been laid off.

In 2019, candidate Biden tweeted a *Time* magazine article titled "Non-Compete Clauses Are Suffocating American Workers," accompanied by the following caption: "We should get rid of noncompete clauses and no-poaching agreements that do nothing but suppress wages."

> It's simple: companies should have to compete for workers just like they compete for customers. We should get rid of non-compete clauses and no-poaching agreements that do nothing but suppress wages. https://t.co/lEipvZdShu
>
> — Joe Biden (@JoeBiden) December 24, 2019

Most recently, President Biden was explicit during his campaign in calling for federal legislation that would eliminate all employee noncompete agreements, other than "the very few that are absolutely necessary to protect a narrowly defined category of trade secrets."

It is also very probable that the FTC will act in response to the Order, given that the agency has been under pressure for several years to exercise its authority to curb using noncompetes. A group of state attorneys general wrote to the FTC in late 2019, urging the agency to take rulemaking action that would ban or limit noncompetes as unfair restraints on trade. On January 9, 2020, the FTC held a public hearing to examine whether there is a legal basis for promulgating a rule to restrict the use of noncompetes. The agency is thus already in a position to carry out the president's edict.

Hostility toward noncompetes is nothing new. Although noncompete agreements are a vital part of every company's efforts to protect its confidential information, trade secrets, goodwill, and other legitimate business interests, most jurisdictions disfavor noncompete agreements because they restrict trade. Furthermore, employees often lack bargaining power when signing such agreements.

That hostility is evident from the fact that California, North Dakota, and Oklahoma each have laws on the books that effectively outlaw noncompetes in all but a few very narrow exceptions. The District of Columbia recently joined the ranks of states with a near-total ban on the use of noncompete agreements when it passed the Ban on Non-Compete Agreements Amendment Act of 2020, which went further than any law before it by outlawing the use of agreements or maintenance of policies that prohibit workers from performing services for compensation after employment and during employment.

Meanwhile, Illinois, Maine, Maryland, Massachusetts, New Hampshire, Rhode Island, Virginia, and Washington state have preferred banning noncompetes for "low-wage workers" rather than instituting *per se* bans on the use of the agreements.

State definitions of "low wage" vary widely. Maryland, for example, set its threshold at about US$32,000 annually, while Washington state set its threshold at US$100,000 annually for employees and $250,000 for independent contractors.

In jurisdictions where the state legislature has not acted to ban or limit noncompetes, courts generally consider, among other factors, whether the scope of a noncompete agreement:

1. Is narrowly tailored to the employer's legitimate business interest;

2. Is unduly burdensome on the employee's ability to earn a living; or

3. Violates public policy to determine the enforceability of a noncompete.

In the past several years, noncompetes have become a focus for federal and state legislatures and agencies looking to reform perceived inequities that arise from the use of noncompetes. As of the writing of this article, there are approximately 45 bills pending to modify existing noncompete law across some 21 states. These range from bills that would ban noncompetes for certain professions, such as physicians, to salary level limitations to outright bans.

Given the impending possibility of an FTC rulemaking limiting or banning the use of noncompetes and similar action at the state level, employers with legitimate protectable business interests should act now to finalize agreements that are more likely to pass muster in the years ahead. In looking to a future where noncompetes are not an option, an employer must carefully analyze options that are truly directed at protecting their business interests.

In reality, there are several options that can go a long way to accomplishing the same objectives as a noncompete. The following are some of these options, which can be used either alone or in some combination to accomplish the same objectives that underpin the need for most noncompetes.

Non-disclosure agreements

The most basic agreement employers should have in place is a strong non-disclosure agreement. Such an agreement can include post-employment prohibitions on the use of confidential information and trade secrets with enough breadth that the company's business interests are fully protected.

These clauses (or even a separate clause) should also specify ownership of any intellectual property and any inventions created during the employment period. Further, such an agreement can provide for the shifting of attorney's fees to continue disincentivizing any improper use of company information.

Such a clause can also build on the concept of inevitable disclosure. The doctrine of inevitable disclosure is often used as a tool to enjoin competitive employment where it would be inevitable that a former employee would disclose trade secret information in his or her new position. This includes inadvertent disclosures, on the theory that an employee cannot completely compartmentalize information and would almost necessarily use the previous employer's trade secrets.

> Confidentiality and non-disclosure agreements are generally the most widely accepted type of post-employment restrictions.

Not all jurisdictions recognize this doctrine and courts have had mixed reactions to its use as the basis for a breach of contract action, but it is possible to craft a non-disclosure agreement in such a way that leverages the doctrine to support certain prohibitions set forth in an agreement.

As with any post-employment clause, the key would be to draft the clause to be as specific as possible. For example, including an acknowledgment that, as a consequence of their employment, the employee obtained training and knowledge specific to “x” and that it would be inevitable that this information would be disclosed in the event the employee ever works for a company that also specializes in “x.”

Confidentiality and non-disclosure agreements are generally the most widely accepted type of post-employment restrictions. Courts will find them unenforceable in some circumstances, but for the most part, if there is sufficient consideration and the terms are reasonable, these clauses are typically enforced. Such a clause can therefore be one of the strongest options for employers looking to protect their business interests.

Non-solicitation agreements

As with confidentiality agreements, non-solicitation agreements can be a critical tool for employers seeking to protect their business interests. These agreements can be crafted in a number of ways, but can also include non-interference and no-service clauses of clients or prospective clients to further protect the business. Again, including a fee-shifting provision adds an additional layer of protection for the company.

Generally, courts favor these types of agreements more than noncompete agreements, but they will still evaluate whether they are unlawful restraints on trade. As with noncompete agreements, the success of a non-solicitation agreement depends in large part on the definition of the prohibitions. For example, in *Update, Inc. v. Samilow*, an employer was granted a preliminary injunction on the basis that an ex-employee had breached his non-solicitation agreement.

The court dismissed the ex-employee's argument that the clause was overbroad because the clause only prohibited the solicitation of clients in two narrow categories: those in the same geographic area as the company and clients with whom the ex-employee had worked. The clause was even further narrowed by barring only solicitation for the purpose of diverting business from the company.

Garden leave

Garden leave agreements may be an attractive option for some employers. Its provisions are common practice in the United Kingdom and much of Europe, but have only recently come into favor in the United States.

> The advantage of these agreements is that new contacts can be cultivated with current employees, thereby making it more likely that the client will remain with the company.

These agreements usually provide for an extended notice period for an employee — sometimes up to six months. During that notice period, the employee remains employed by the company, but is not actively working. Instead, they “tend their garden,” remaining on the sidelines for a period of time. The advantage of these agreements is that new contacts can be cultivated with current employees, thereby making it more likely that the client will remain with the company.

The enforceability of these provisions is not always clear, as there is limited case law on the issue.

Generally, however, courts will look at the provisions with the same scrutiny as noncompetes, evaluating their reasonableness against the employer’s protectable business interests.

For example, in *Bear Stearns & Co. v. Arnone*, a New York court evaluated the reasonableness of a garden leave clause and enforced it against a broker who had contacted clients during her garden leave period to inform them of her contact information for her new employer, a competing firm. The court issued an injunction prohibiting her from any further contact with those clients.

Yet, in *Bear, Stearns & Co., Inc. v. Sharon*, the Massachusetts District Court evaluated the same clause and refused to grant a preliminary injunction preventing a broker from going to work for a competing firm during his contractual garden leave period. The court found that such an injunction would be against public policy, but noted that the company would likely prevail in a breach of contract action against the employee.

This case demonstrates the usefulness of a garden leave provision. While not a perfect replacement for a noncompete, such a provision does provide for the potential recovery of damages in the event an employee leaves for a competitor.

Forfeiture-for-competition clause

Another option for employers looking for an alternative for a noncompete agreement would be a forfeiture-for-competition clause or agreement. Such a clause or agreement would provide that if the employee competes, they would forfeit certain benefits such as severance pay, stock incentives, deferred payments, or earn outs that are contractually conditioned on the employee limiting their post-employment competition for some period of time.

Courts differ in how they interpret such a clause, but the general analysis moves from considering whether the clause is an unreasonable prohibition on trade, to considering only whether the competing employee must forfeit the monetary benefits as provided in the contract. This change makes it more likely that the agreement will be upheld, as courts look more favorably on forfeiture of monetary benefits than a clause restraining a person from employment. Generally, such clauses are subject to a lower level of scrutiny than a noncompete agreement.

While the clause may deter an employee from competing, the anti-competition element of the clause does not need to be scrutinized for reasonableness because the employee is not being deprived of their livelihood. The employee has a choice between rights to the benefits or competitive employment and is trusted to make that choice based on what is more beneficial for them.

In *Fraser v. Nationwide Mutual Ins. Co.*, the Federal District Court for the Eastern District of Pennsylvania followed this reasoning by holding that such a clause is rational because each party has the freedom to act in its best interest.

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As the court explained, “Nationwide did not impede Fraser from working for another company by the threat of injunction — rather, Fraser was simply faced with the decision of whether or not to disqualify himself from a monetary benefit. In all likelihood, Fraser made that decision as any rational actor would — by weighing the benefits and losses attributable to each option.”

This doctrine is not without its limits, however. In *Lucente v. IBM*, the Second Circuit considered the employee choice doctrine, but went on to state that the doctrine does not apply if the employee was involuntarily terminated, as there was no longer a choice for the employee to make when it comes to future employment.

Some courts will evaluate such clauses as they would a traditional non-competition clause when the terms or amounts of money involved effectively deprive the employee of a choice. For example, the Supreme Court of Connecticut held that a forfeiture-for-competition clause involving a substantial sum of money was a restraint against competition to which the traditional noncompete analysis applied, per *Deming v. Nationwide Mutual Insurance Co.*

In *Deming*, the employer’s deferred compensation plan required its sales employees to forfeit hundreds of thousands of dollars in commissions and deferred compensation that had been earned over the course of their entire careers in exchange for their choice to compete. The court, while stating that the amount of the forfeiture alone should not determine whether the clause is enforceable, concluded that the forfeiture of *accrued* benefits subjected the employees to an economic loss that was unreasonable.

Given the above, there are precautions to consider when drafting an effective forfeiture-for-competition clause.

1. Consider state law and court analysis in the jurisdiction of the contract. Courts analyze these clauses in several different ways and leveraged law of the specific jurisdiction at issue as an essential first step in drafting.

2. These clauses cannot require that an employee forfeit wages or compensation that is equivalent to wages. Stock incentives, management incentive bonuses, or separation payments would be types of compensation that are more likely to be regarded as compensation that supports a forfeiture-for-compensation arrangement, while commissions

and ordinary bonuses would not (and may even run afoul of state wage payment laws).

3. Understand the limitations of such a clause. A forfeiture-for-competition clause does create a ceiling on the recovery against a competing party, in some instances the agreed forfeiture amount might be less than the actual loss.

Additionally, the business decision with respect to amounts of forfeiture can be tricky. Too high of a forfeiture may lead to a circumstance such as the one in *Deming*, but too little may not discourage employees from competing.

“Bad boy” provisions

Following a similar rationale as forfeiture-for-competition clause, employers could also consider a so-called “bad boy” provision. As the name would imply, in the event an employee commits certain “bad acts,” such as disclosing the employer’s confidential information or trade secrets, disparaging the employer, or poaching employees or clients, they would be required to repay some monetary compensation.

As with a forfeiture-for-cause clause, any such clause cannot claw back compensation that would be considered wages, and would have to be calculated to deter the unwanted conduct without being punitive. Interestingly, these clauses may be employed even during employment, such as requiring the payback of an incentive for failing to follow company policies or committing a serious act such as fraud.

While these clauses do put a limit on recovery for an employer, such prohibitions and a definite monetary consequence spelled out for employees can be a more powerful deterrent than a more general clause that would result in factual disputes over whether there has been a breach and the resulting damages.

A new world

Employers must come to terms with a world where standard noncompete and non-solicitation agreements may no longer be an option. Companies should consider using some combination of the clauses and approaches discussed in this article as alternative methods of protecting their legitimate business interests, but they must understand the legal landscape in the jurisdictions where they operate and approach the process of drafting (or redrafting) agreements carefully to ensure enforceability.

Shamir Patel

Deputy General Counsel

Guidehouse

Shamir Patel is deputy general counsel at Guidehouse.

Olaoluwaposi O. Oshinowo

Special Counsel

Wiley Rein LLP

Olaoluwaposi O. Oshinowo is special counsel in Wiley Rein LLP’s Employment & Labor Practice.

Martha G. Vázquez

Associate

Wiley Rein LLP

Martha G. Vázquez is an associate in Wiley Rein LLP’s Employment & Labor Practice.