

Restrictive Covenants in Sale of Business and Employment Contexts

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Restrictive Covenants in Contexts of Sales of Business Interests and Employment

Today's Topics:

1. What Constitutes a Restrictive Covenant, and who should be asked to sign them?
2. Legal Standards and Choice of Law
3. Drafting for Enforceability (or not)
4. Amendments
5. Tips for Enforcement
6. Defending Claims for Enforcement
7. Evolving Case Law and Trends



What Constitutes a Restrictive Covenant and Who Should be Asked to Sign them?

Types of Restrictive Covenants

- Confidentiality covenant (information)
- Invention Assignment (IP)
- Non-competition covenant – Knowledge and association with the business (products, services, goodwill)
- Non-solicitation covenant (customers, employees, other business relationships)

Importance of Restrictive Covenants

- Key to protecting companies' significant investments in their confidential information, purchased and accumulated business knowledge and goodwill, and business relationships and employees.
- Sale of business (M&A - asset or stock sales, transfer of stock or membership interests, etc.) – protects the business purchased
- Employment – protects the business shared or created with Company resources

Why Allow Restrictive Covenants?

- Businesses invest a great deal in people, products, processes, information, business relationships
 - These business interests belong to the Company
 - Employees given access and resources, paid for their work
- Common law, and statutes in some states allow for restrictive covenants as exceptions to limits on restraints on trade
 - Purpose: encourage business and business relationships
 - By clarifying what “belongs to the business,” i.e., what business interests outweigh an individual’s right to compete with his former employer to earn a living

Restrictive Covenant = State Law Contract

- Restraint on Trade – must meet requirements for common law or statutory exceptions to that law
- Protect “*legitimate, protectable business interest*” from interference by those with whom a business shares it for business purposes
- Generally, a company can protect that which it shares with, or funds creation by, the contracting person
 - Confidential information, IP
 - Knowledge regarding and association with the business (products, services, goodwill)
 - Business relationships (customers, employees)
 - Restriction must be “*reasonably necessary*” to protect...

Overview of Restrictive Covenant Law

- Creatures of law and of equity
 - **Contract terms** – what did the parties agree, and do those terms align with statutory and common law (e.g., necessary to protect a legitimate, protectable interest)?
 - **Equity** – Is the restriction fair to the restricted party and the public, under the circumstances that will exist at the time of enforcement?

What Law Governs Enforceability?

- Currently, no federal law (but see section on Trends)
- State law – choice of law provision vs where the contract is entered vs where the restrictions apply/are enforced
 - Choice of law provisions recognized in most states, if not against public policy.
 - NC generally enforces choice of law provisions
 - Some states expressly reject choice of law provisions (e.g., CA).
 - Generally, a court in a state with a stricter covenant law is not likely to apply (or as liberally apply) the law of a state with more lenient standards or that authorizes the court to modify an agreement to make it enforceable, and, enforce it as modified.
 - “Blue penciling” in VA vs. NC

What Law Governs Enforceability?

- Most states require some form of reasonableness as to time, territory and scope of business/customers that are restricted
 - General concept that flows through the laws of all the states allowing restrictive covenants
 - A covenant that protects “*legitimate, protectable business interests*” and is “*reasonably necessary*” to protect those legitimate business interests
 - interpreted more or less strenuously in different states
- Other state-specific legal restrictions

Employer's Legitimate, Protectable Interests

- **Legitimate, protectable business interests include:**
 1. Valuable information as to the nature and character of the business.
 - Not limited to trade secrets
 2. Customer or client relationships and goodwill
 3. “Integrity and viability of the business”
 4. Current employee relationships
- **An employer has no legitimate, protectable business interest in:**
 1. Common knowledge
 2. Restricting “ordinary competition”
 3. Restricting activities that have no material bearing on employer’s business
 4. Prior customer relationships the Company did not materially contribute to building/keeping/enhancing

If the employer does not have a legitimate business interest, a covenant is not enforceable for any period or any geographic area!!

Not Legitimate, Protectable Interests

- Information:
 - Common knowledge, information available outside the business
- Inventions:
 - Created without use of Company resources or compensation
- Anti-trust violations
 - Companies cannot agree not to compete with each other for business, customers or employees

Reasonably Necessary for Protection of Employer's Legitimate, Protectable Interests

- **Reasonably necessary includes:**

1. Nondisclosure, non-use of confidential information that the employee was exposed to
2. *for a reasonable time after employment/sale, not:*
 - a) using specialized training and business knowledge to compete
 - b) interfering with Customer or client relationships that the Company paid/allowed employee to build/access,
 - c) Not interfering with employee relationships

- **Not reasonably necessary to protect legitimate, protectable business interests:**

1. Protecting common knowledge or publicly available information
2. Restricting competition under circumstances where *the contracting party did not gain any special competitive edge as a result of employment / association with the assets sold*, e.g.:
 - a) business the contracting party did not engage in or learn material confidential info about
 - b) geographical areas where the contracting party did not engage in (establish a presence in) the business
 - c) Customers the contracting party had no interaction with and did not learn confidential info about

If the restriction is not reasonably necessary, it is not enforceable

Who Should Sign Restrictive Covenants?

- Not everyone bc not “reasonably necessary” to protect ...
- Owners/Sellers (M&A, stock/MI transfers)
- People who are the “Face of the Company”
 - Board members, Execs, Managers
 - Employees with material customer contact (e.g., sales, account managers)
- Those who develop / have material access to trade secrets, confidential information about the business or customers
- Some states - salary restrictions (MD, WA)



Drafting for Enforceability (or not)

No One Size Fits All Restrictive Covenants

- To be enforceable, restrictive covenants must be “narrowly tailored” to protect the Company’s “legitimate, protectable business interest”
 - Easier in the context of sale of business – the covered “Business” is defined by the purchase agreement and as an owner the Seller touched all of it
 - Employment context: you must limit to the Business and Customers the contracting party will learn about, engage with, etc.
 - Not the same for all employees
 - Predict the circumstances that will exist at time of enforcement

No One Size Fits All Restrictive Covenants

- Be careful using forms, even with multiple options for enforcement
 - “the business of the Company”
 - “and its Affiliates”
 - “the world, United States, Canada, specific states, counties, etc.”
- Courts have found not “narrowly tailored”
 - Covers Business, Customers the contracting party did not touch
 - Company did not attempt to “narrowly tailor,” instead leaving this job to the court
- Questions to ask:
 - Can the restricted party reasonably predict from the language the Business and Customers that are restricted?
 - Are those limited to the ones that the restricted party touched?
 - Is the restricted party in an unfair position to compete bc of that?

Know the Nuances of Applicable Law

- Some states do not allow non-competition covenants (CA, ND, OK), some states exclude certain types of employees E.g.,
 - certain types of professions (DE, NY), non-key employees (MD, IL), etc.)
- All RCs require consideration
 - most states (NC, DE, NY) allow initial employment
 - some states (DE, NY, etc.) allow continued employment (Remember – if employment is in context of a stock sale, no new employment)
 - Some require employment time to be substantial (DC, MD, etc.)
- Some states require pre-employment notice (MA), some invalidate covenants signed before employment starts (AL)

Know the Nuances of Applicable Law

- All states require reasonable time, territory and scope
 - Each state has its own interpreting case law, some have statutes
 - Some states (DE, NY) will reform to enforce (“blue pencil”)
 - Some states (NC, DC) will strike the unenforceable portions and enforce the rest if the terms are severable (“red pencil”)
 - Some states will not revise at all (SC, VA, WI) (“no pencil”)
- Blue Penciling
 - A court in a red pencil or no pencil state is not likely to enforce a choice of law provision that selects a blue pencil state’s law (because it is against public policy).
 - But, a court in a blue pencil state may enforce the laws of a red pencil or no pencil state.
 - Whether you want reformation or not depends on which party you represent

Covenants in Sale of Business Context

- Legitimate, protectable business interest: protecting the assets sold
 - The limited nature of these covenants is why they are more leniently enforced.
- Limit restrictions to the scope of business actually engaged in by the Seller, in the geo where the Seller actually conducted that business, within a reasonable lookback period (usually 1 – 2 years).
 - Do not try to rope in Buyer's business, unless material information that gives the Seller an unfair advantage in competing with that business has been provided in due diligence.

Covenants in Sale of Business Context

- Only parties receiving consideration from the sale
 - Receiving new employment as a result of the sale is not enough
- Restrictions run from closing. Up to 5 years in most states. We typically see 3 – 5.
 - Do not try to bootstrap these restrictions into an employment agreement “required as part of the consideration for the sale,” to get a longer restricted period.

Non-Solicitation Covenants

- **Customers**: Many states allow a customer restriction to substitute for a geographical restriction
 - The restriction still must be “narrowly tailored” to those that are “reasonably necessary” to protect only the customers as to whom the Company has a “legitimate, protectable business interest,”
 - i.e., customers with whom the employee had contact with or learned confidential information about.
- **Employees**: employee solicitation restrictions are generally considered enforceable so long as they are reasonable
 - Very little case law interpreting

Confidentiality Covenants

- Contracts not in restraint of trade may be unlimited in time and geographic scope, as long as they protect a legitimate business interest.
- A contract is not in restraint of trade “if it does not seek to prevent a party from engaging in a similar business in competition with the promisee but instead seeks to prevent the disclosure or use of confidential information.” *ChemiMetals Processing v. McEneny*, 124 N.C. App. 19, 476 S.E.2d 374 (1996).
- Confidentiality agreements need not be limited as to time and territory.

Covenants During Employment vs After

- Often, RCs prohibit conduct both during and after employment
- Generally, RCs during employment are enforceable
 - E.g., prohibition against conducting competing business, working for a competitor, enticing away customers, etc.
- Often language is not carefully drafted, e.g., the agreement may say that the behavior is prohibited during and after employment but then
 - define the restricted scope with reference to a lookback running backwards from end of employment and/or
 - define the restricted period as a period following employment

Don't Fall Into the Pitfall of Imprecise Drafting

- Define terms precisely, narrowly tailored to protect legitimate business interests.
- Overbroad terms are unenforceable and can make an entire covenant fail.
- Examples:
 - All business conducted by the Company or Buyer or their affiliates, when the contracting party only engaged in a portion of that business
 - All customers and prospective customers of the Company or Buyer, not just those whom the contracting party has a relationship with and therefore an unfair advantage
 - Overbroad geography -- where the Company thinks of itself as doing business (e.g., North America) but the Company or Buyer does not actually conduct business in the whole area

Tips for Drafting Enforceable Restrictive Covenants

- Limit time to 1 year.
- Limit restricted business to business that the company actually engaged in.
- Limit restricted activities to those contracting party performed.
- Limit geographic scope to the smallest describable geo where company engaged in the business.
- Limit customer restrictions to customers promisor had contact with or learned confidential info about.
- Avoid automatic renewals.

Amendments

Restrictive Covenants May Be Amended

- Changes contract terms – in most states new consideration is required
- Change in the terms and conditions of employment:
 - Pay raise
 - Cash bonus (e.g., \$500)
 - Promotion
 - New job assignment
 - Termination only for cause
 - Incentive-based compensation
- All other requirements of enforceability also must be met.

Tips for Enforcement

Enforcement Steps

1. Figure out what law applies and anticipate arguments for and against enforceability.
2. “Cease and Desist Letter”
 - Send reminder of restrictive covenants (and notice of breach if any).
 - Not legally required but some judges expect this step before you seek injunctive relief
 - Require return of confidential information.
 - Seek explanation/assurances of compliance.
 - Litigation hold and preservation notice.
3. Put new or prospective employer on notice (*i.e.*, potential claim for tortious interference).
 - Some agreements limit this.
 - Some state/local laws limit.
4. Seek injunctive relief in a timely manner.

Courts' Views of RCs Generally (NC, for Example)

- Restrictive covenants are “disfavored by law.” *Medical Staffing Network, Inc. v. Ridgway*, 194 N.C. App. 649, 670 S.E.2d 321 (2009)
- Because they are in “restraint of trade,” they must be “carefully scrutinized.” *ChemiMetals Processing, Inc. v. McEney*, 124 N.C. App. 194, 476 S.E.2d 374 (1996).
- To be enforceable, restrictions “must be no wider in scope than is necessary to protect the business of the employer.” *Manpower v. Hedgecock*, 42 N.C. App. 515, 257 S.E.2d 109 (1979).

NC Requirements for Enforceability of a Covenant Not to Compete

To be enforceable, covenants not to compete must be:

1. In writing and signed;
2. Made part of the contract of employment (or business transaction);
3. Based on valuable consideration;
4. Reasonably necessary for the protection of the employer's interest; and
5. Reasonable as to time and geographic scope

Signed Writing: NC Statute and Common Law

- N.C. Gen. Stat. § 75-4: “No contract or agreement hereafter made, limiting the rights of any person to do business anywhere in the State of North Carolina shall be enforceable unless such agreement is in writing duly signed by the party who agrees not to enter into any such business within such territory”
- Must Be Made Part of the Employment Contract: Must be entered into at the time of employment and as part of the employment contract OR be supported by new consideration.

Was \$Valuable\$ Consideration Provided?

- Was the covenant signed by a seller getting consideration in a sale of a business, or at inception employment, or in exchange for something?
- Or does the law of a state allowing continued employment to suffice apply? (27 states, including AL, AZ, AR, CO, DC, DE, FL, ID, IN, KS, LA, MD, ME, MI, MS, MO, NE, NH, NJ, NY, OH, SD, TN, UT, VT, VA, WI).
 - Note some states require a significant period of continued employment (DC, ID, KS, ME, MD, TN)



Was \$Valuable\$ Consideration Provided?

- If entered during employment, what was the new consideration?
- Are there automatic renewal provisions?
 - May require new consideration for each renewal
 - *Am. Air Filter Co. v. Price*, 2017 NCBC LEXIS 55 (Wake Bus. Ct. June 26, 2017) (Kentucky law)
 - “Any failure to provide consideration for a given year's renewal would break the ‘chain’ and render the 2006 Agreement unenforceable as to subsequent years.”
 - Covenant ran from termination of the non-compete agreement, and not termination of employment.



What Can Be Sufficient New Consideration?

- Change in the terms and conditions of employment:
 - Pay raise
 - Cash bonus (e.g., \$500)
 - Promotion
 - New job assignment
 - Termination only for cause
 - Incentive-based compensation
 - Stock options
- Must be specifically tied to covenant (*i.e.*, not a new benefit provided to all employees).



What Can Be Sufficient New Consideration?

- NC: consideration is typically sufficient if not “grossly inadequate” or “illusory”
 - If consideration is stock options, were they ever exercisable and do they have value?
 - Was there a real chance the stock would increase in value and did it?
 - Mere eligibility for additional compensation or compensation entirely in management’s discretion is insufficient.
- Caution: Some states have passed laws requiring material or substantial consideration or genuine advancement.
 - Oregon requires “bona fide advancement”



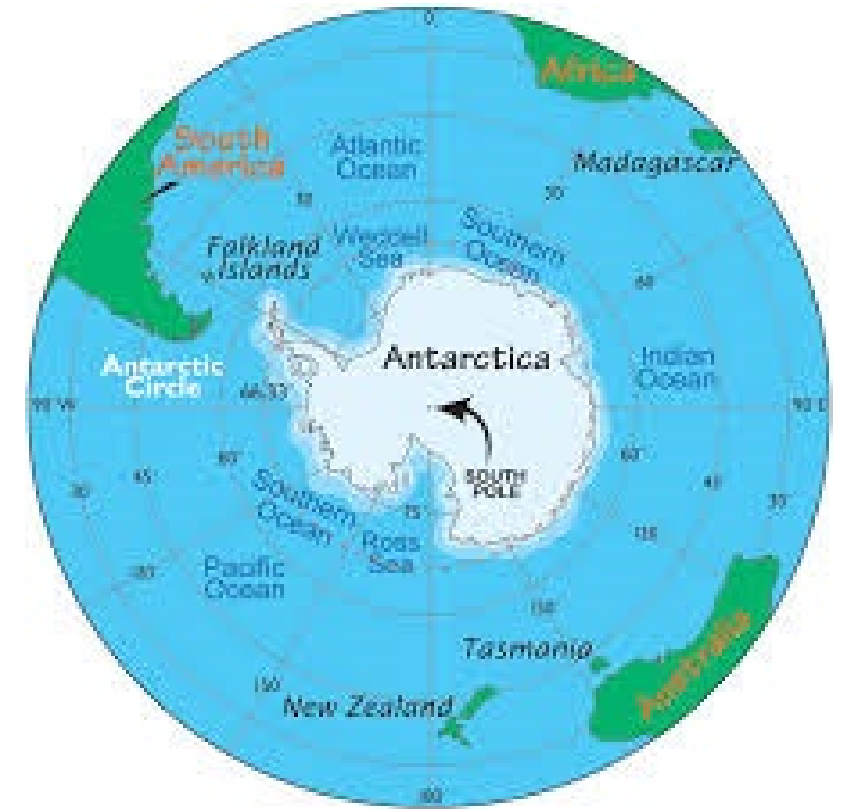
Is the Restricted Period Reasonable?

- Considered in tandem with geographic scope, nature of industry, and scope of activity
- “Lookback” period must be added
- 5 years is “outer limit” and often found to be “excessive” and can be supported only by sale of business or “extreme conditions”
- 2-3 years depends on scope and geography
- We generally recommend 1 year because we have seen it enforced consistently.



Is the Geography Reasonable?

- Considered in tandem with restricted time period, nature of industry, and scope of activity, not in isolation
- Must be limited to geo areas where restricted party conducted the restricted business
- Name of locality or a specified mile radius
- A customer restriction may substitute for a geographic restriction
 - Cannot extend beyond those customers for whom contracting party has an unfair advantage because of association with the business (e.g., contracts, access to confidential info, etc.)



Reasonable as to Geographic Scope (NC, for Example)

Held to Be Reasonable

- 1 year within 7-mile radius
- 2 years in county of employer and surrounding counties
- 3 years within 15-mile radius
- 1 year within 50-mile radius of assigned office
- 2 years throughout continental U.S.
- 6 months throughout North and South America not per se unreasonable

Held to Be Unreasonable

- 5 years in all of NC and SC (employer operated in only limited areas)
- Worldwide restriction on sales director for North America and Europe
- 2 years in states or areas where employer may or intends offer services*
- Places the employer had done business*

***Contracting party must be able to know what geography is restricted based on his or her experience with the business.**

Is the Scope of the Restricted Business Activity Reasonable? (NC Examples)

- Affiliated Businesses: “MSN presented no evidence, and the trial court made no findings that MSN had any legitimate business interest in preventing competition with, foreclosing the solicitation of clients and employees of, and protecting the confidential information of an unrestricted and undefined set of MSN's affiliated companies that engage in business distinct from the medical staffing business in which Ridgway had been employed.” *Medical Staffing Network, Inc. v. Ridgway*, 194 N.C. App. 649, 670 S.E.2d 321 (2009)
- Business Buyer Ceases Business: If the buyer ceases business, there is no longer a protectable interest. *Hertzberg v. Fur Specialists, Inc.*, 781 S.E.2d 533 (N.C. App. Ct. 2016).
 - There could be a claim for UDTPA violation, employee raiding, or theft if a whole business is taken.
- Geographic Scope Beyond Current Business: Geographic scope generally cannot exceed present business activity. *Beverage Sys. of the Carolinas, LLC v. Associated Bev. Repair, LLC*, 368 N.C. 693, 784 S.E.2d 457 (N.C. 2016).

Will the Court Reform the Agreement? (NC, for Example)

- The party seeking enforcement has the burden to prove reasonableness.
- Red Pencil versus Blue Pencil
- In NC, courts have discretion to “red pencil” overly broad restrictive covenants.
 - Strike offending portions and enforce the rest, if the terms are severable
 - A NC court may or may not apply a choice of law provision selecting the law of a blue pencil state (DE); depends on the judge you draw and the state law.
 - Some “blue pencil” state laws require reformation.
 - Others allow reformation in the discretion of the judge.

Restrictive Covenant Law in Delaware

- Some courts will enforce a DE choice of law provision if the parties have some reasonable relation to DE.
- Others will not.
- DE restrictive covenant law generally is more favorable to employers than other states.



Restrictive Covenant Law in Delaware

- Continued employment alone is sufficient consideration for restrictive covenants for at-will employees.
- Courts may “[blue pencil](#)” overly broad restrictive covenants.
- Restrictive covenants covering limited geographic areas for two or fewer years generally are held to be reasonable.
 - In sales of businesses, DE courts have upheld restraints as long as ten years, where the activity restrained and geo area were limited.
- DE courts have proved willing to approve restraints that are national in scope under appropriate facts (e.g., true national business).

Restrictive Covenant Law in California



- General rule: covenants not to compete are void under CA law.
- Cal. Bus. and Prof. Code § 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 void.”
- All non-competes between employers and employees/independent contractors are void.

Restrictive Covenant Law in California: Exceptions to General Rule

- Confidentiality and non-disclosure agreements that protect trade secrets and confidential information generally are enforceable.
- CA courts will enforce very narrow non-solicit aimed at protecting confidential information (e.g., customer lists); general non-solicitation covenants are prohibited.
- Cal. Bus. and Prof. Code § 16601: “[A]ny person who sells the goodwill of a business, or any owner of a business entity selling or otherwise disposing of all of his or her ownership interest in the business entity” may agree not to engage in similar business in a specified geographic area.
 - Seller must receive compensation for goodwill as part of purchase price.
- Cal. Bus. And Prof Code § 16602.5: A member of an LLC may agree not to compete “upon or in anticipation of a dissolution of, or termination of his or her interest in” the LLC.

Enforcing Restrictive Covenants: How To Discover and Prove a Breach

- Timing of lost business
- Industry word of mouth
- Check web presence
- Best leverage: was confidential info taken in violation of a covenant?
 - Demonstrates bad intent
 - Forensic review of devices
 - Look for customer contact, trade secrets, confidential info, and forms taken
- Good leverage: will customers testify via affidavit or in person?



Avoiding and Defending Claims for Enforcement

Avoiding Claims for Breach of and Tortious Interference with Restrictive Covenants

- Enter into written agreement with new employees requiring them not to bring or use anything belonging to a prior employer
- Review the restrictive covenants in detail and require employee to follow them
- Provide script for and document contact with customers independent of prior employer's info.
- Prior to separation from employment or business:
 - Document return of confidential and proprietary information.
 - Make sure information is deleted from all personal electronic devices.

Defending Claims for Breach and Tortious Interference with Restrictive Covenants

- Review the restrictive covenants in detail
- Determine arguments for and against enforceability:
 - Adequate consideration?
 - Protectible interest?
 - Reasonable time?
 - Reasonable geographic scope?
 - Customer restrictions limited to customers with whom client had personal relationship?
 - Business activity restrictions limited to promisor's business?
 - Business activity restrictions limited to those the client engaged in?

Defending Claims for Breach of and Tortious Interference with Restrictive Covenants

- Prepare to defend against motion for preliminary injunction:
 - Lack of irreparable harm
- In claims for breach of a non-solicit, determine whether there in fact was a “solicitation.”
 - Affirmatively asking for customer’s business versus informing the customer of a change in employment.
 - Former employees can “accept” customers’ business without violating the non-solicit (difference between a non-solicit and a non-compete).

Evolving Case Law and Trends

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Bye-Bye Restrictive Covenants?

- **Workforce Mobility Act of 2019** – a bipartisan bill introduced October 17, 2019 (Senator Chris Murphy (D.-Conn.) and Todd Young (R.-Ind.))
 - To limit the use of non-compete agreements.
- “[N]o person shall **enter into, enforce, or threaten to enforce** a non-compete agreement with any individual who performs work for the person and who in any workweek **is engaged in commerce or in the production of goods for commerce**”
 - Would invalidate agreements already in place
 - Companies will lose benefit of bargain.
 - How will this affect agreements these are part of?
 - Exceptions: covenants in connection with dissolution of a partnership or sale of a business.
- Could be significant support for it.
 - In recent years, Senators Elizabeth Warren (D.-Mass.) and Marco Rubio (R.-Fla.) introduced other bills to limit or prohibit non-competes.

New State Law Limitations

- Public opinion disfavors non-competes:
 - Employee lacks bargaining power at the time of employment.
 - Unfairly restrict ability to make a living because the company in better position to bear the burden of competition than the employee is to bear the burden of unemployment.
 - Too broadly applied – employees with no real ability to compete.
- Recently Enacted State Limits on Non-Competes (2019-2020)
 - Maryland
 - Voids non-competes for employees who earn equal to or less \$15 per hour or \$31,200 per year.
 - Does not apply to agreements relating to confidential or proprietary information.

New State Law Limitations

- Recently Enacted State Limits on Non-Competes (2019-2020)
 - Oregon
 - Must notify new employees of non-compete agreement at least two weeks before the first day of employment.
 - New non-compete agreements require “subsequent bona fide advancement” of the employee.
 - Washington
 - Voids non-competes for employees who earn less than \$100k per year and independent contractors who earn less than \$250k.
 - Non-competes 18 months or longer are presumptively unreasonable and unenforceable.
 - Voids non-competes for laid off employees unless the employer compensates the employee with previous base pay for the period of enforcement.

New State Law Limitations

- Recently Enacted State Limits on Non-Competes (2019-2020)
 - Rhode Island
 - Prohibits non-competes for employees whose average annual earnings are at or below 250% of the federal poverty level.
 - New Hampshire
 - Prohibits non-competes for employees earning hourly wages of less than or equal to 200% of the federal minimum wage.
 - Maine
 - Prohibits non-competes for employees earning wages at or below 400% of the federal poverty level.
 - Non-compete cannot have an effective date until after one year of the employee's employment or six months from the date the non-compete was signed, whichever is later.

Questions?

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