HR Preparedness Advisory

NON-COMPETE AGREEMENTS AND TRADE SECRETS

INTRODUCTION

Whenever an employer hires a new employee, the employer provides that person with access to the organization's most valuable assets: its people, its customers, and its way of doing business. Given that the average American will change jobs seven times over a work life, chances are high that some of that information will eventually find its way to a competitor. More frequently than ever, companies are trying to protect themselves and their assets from the damage that can result when employees depart to work for a competing business or set up a competing enterprise.

An employer should require employees to sign employment agreements wherein they agree to maintain the secrecy for all of the organization's trade secrets. In addition, an employer may consider a covenant not to compete that has geographic, scope, and duration limitations. Such terms should be included in an initial employment agreement entered into at the start of the employment relationship. While it may not be easy to go back and add these terms, because there must be adequate consideration in exchange for these post-employment obligations, if an employer will be paying the employee anything more than absolutely legally owed, the employer may be able to condition the bonus on having signed an agreement to maintain the trade secret as confidential and to provide the employer with written assurances that the employee no longer has any proprietary or trade secret material.

Please note, however, that state law governs restrictive covenants, trade secrets, and other noncompetition agreements. While many of the general legal principles set forth here apply universally, there can be significant differences among states. The most obvious distinction is that some states, notably California, prohibit restrictive covenants that inhibit an employee's ability to find new employment. Other distinctions among the laws of various states may be less dramatic, but under certain circumstances, no less important. Such differences are particularly critical if the agreement is intended to apply to employees who may be located in different states, such as a sales force. The substance of individual state laws is beyond the scope of this discussion, which is intended to offer a general understanding of the concepts involved. Individual state laws should be reviewed before any agreement discussed in this material is drafted.

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GENERAL PROTECTIONS

Employers have certain limited protections — recognized by the law under a variety of theories — against unfair competition, disloyal employees, and overreaching competitors. Turning legal theory into meaningful remedies requires attention to detail and an appreciation for conflicting public policies.

THE DUTY OF LOYALTY

An organization's current employees are under a "duty of loyalty" to the organization. Each state defines that duty a bit differently. In general, employees are not permitted to induce current customers, suppliers, or other employees to leave the organization, nor are they allowed to operate a competing business while still employed by the organization. When that duty is breached, the employer may be entitled to collect lost profits, punitive damages, and out-of-pocket costs incurred to train replacements. Offending employees may be forced to forfeit their salaries and to give up any profits they made as a result of the disloyal conduct. In addition, courts may issue injunctions forbidding the employees to engage in similar conduct for a specified period. Under the duty of loyalty, the law generally prevents an individual from using trade secrets or proprietary information of a current or former employer to the detriment of that employer.

An employer need not do anything special to create this duty, and the employee need not sign any agreement to be covered by it. The law recognizes the duty of loyalty and the value of proprietary information. When wrongful conduct has been proven, the law provides a remedy. It will, however, be up to the employer to prove in court that the information it seeks to protect meets standards for trade secrets and that it did everything it could to safeguard the secret nature of the information.

TRADE SECRETS

What Is a Trade Secret? A trade secret can be any information that derives independent economic value from not being generally known or readily ascertainable. Among the things that can be trade secrets are formulas, patterns, compilations, programs, devices, methods, techniques, or processes. Among things courts have found to be trade secrets are machining processes, blueprints, stock-picking formulae, customer lists, pricing information, and nonpublic financial data. On the other hand, information such as overhead rates and profit margins that help define a price may be found to be a trade secret even if the price itself is known.

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LEGAL TESTS

Forty-eight states and the District of Columbia have adopted in whole or in part the Uniform Trade Secrets Act (UTSA). The UTSA codifies the basic principles of common law trade secret protection and may afford employers protection even in those states, like California, where restrictive covenants are generally not enforceable. The UTSA protects an employer from misappropriation and misuse of actual trade secrets, which are defined as information, including a formula, pattern, compilation, program, device, method, technique, process, drawing, data, or customer list that:

Derives independent economic value — actual or potential — from not being generally known to or readily ascertainable (by proper means) by other persons who can obtain economic value from its disclosure or use is the subject of efforts that are reasonable under the circumstances to maintain its secrecy. An employer must take reasonable measures to maintain the confidentiality of trade secrets. In determining whether reasonable steps have been taken, courts balance the costs and benefits on a case-by-case basis. Even states that have not adopted the UTSA generally accord similar protection to trade secrets under the Restatement (Second) of Torts, § 757. To determine whether a piece of information is a trade secret, states following the Restatement of Torts will generally examine the following six factors:

- The extent to which the information is known outside the business.
- The extent to which it is known by employees and others involved in the business.
- The extent of measures taken by the business to guard the secrecy of the information.
- The value of the information to the business and to its competitors.
- The amount of effort or money expended by the business in developing the information.
- The ease or difficulty with which the information could be properly acquired or duplicated by others.

RESTRICTIVE COVENANTS

Definition: Restrictive covenants, also known as noncompetition/non-compete agreements, are contractual arrangements that restrict employees' rights to compete with their employers for a period of time following the termination of employment. Once reserved for the highest-level executives, researchers, and outside sales personnel, non-compete agreements are being increasingly used with midlevel managers, technical staff, and any other employee whose departure could create a competitive disadvantage. Unlike the common law duty of loyalty, an

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agreement not to compete prohibits conduct that takes place after the employment relationship has ended and is not limited to "wrongful conduct," such as stealing client lists.

Other agreements are narrower, restricting the only contact with customers. Such an agreement is referred to as a no solicitation agreement. Through the use of noncompete, no solicitation, and nondisclosure agreements, employers try to prevent employees from cashing in on opportunities gained during the employment relationship.

WHAT RESTRICTIVE COVENANTS PROTECT

Restrictive covenants provide protection by preventing former employees from alienating long-standing customers and disclosing or using confidential information acquired from the employer. Note, however, that with professionals such as doctors, accountants, and certain others, where a personal relationship has developed, courts will frequently refuse to enforce a noncompetition agreement that would result in patients not being able to see their own doctor or clients not being able to use the accountant they have dealt with for years.

Employers can protect confidential information that may be helpful to a competitor or to an employee who decides to go into private business. Courts will enforce this protection if an employee has signed a restrictive covenant and the covenant is reasonable in all other important aspects. This is distinct from the general provision provided by the law of trade secrets and is a way for employers to protect themselves against disclosure of information that may not otherwise qualify as a trade secret. An employer must, however, be able to show that the information was indeed treated as confidential.

RESTRICTIONS ON NONCOMPETE AGREEMENTS

Before embarking on a campaign to have employees sign noncompete agreements, companies should consider a few cautionary points. Considering these points will also help companies draft workable agreements. Courts in all states dislike noncompete agreements and welcome the opportunity to limit or eliminate them. Their sentiment is largely based on a desire to allow individuals to earn a living in the field of their choice. Agreements that are too broad are likely to be tossed out or at least rewritten by a judge in those states that allow for such an option.

As a general rule, courts will consider the following factors in determining whether to enforce a restrictive covenant:

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- Does the employer have a legitimate interest in being protected from this employee's competitive activity? A court may refuse to enforce a restriction that is too broadly drafted even though the employer may be able to demonstrate a legitimate business interest worthy of protection.
- Is the restriction reasonable in light of all the circumstances? By "reasonable," the courts would mean that the agreement is no more restrictive upon an employee than necessary to protect the employer's legitimate business interests.
- Is the restriction reasonably limited in time and geography? The agreement must contain a reasonable time restriction. Such a time restriction would be based on such factors as the time it would take to train a new employee and for customers to become familiar with this employee and eliminate the identification between the employer's business and the former employee. The geographical scope of the restriction must be limited to areas necessary to protect the employer's interests.
- Will enforcing the restriction harm the public interest? Will any aspect of public policy be affected if the agreement is enforced? This factor tends to be the least definitive; however, the following example may be illustrative: An employer-hospital requires a restrictive covenant with the only cardiac surgeon in a 500-mile radius, and that surgeon then leaves the hospital. If the restrictive covenant were to require the surgeon to not compete within a 200-mile radius, the public would be severely harmed by this restrictive covenant.
- Was there reasonable consideration given in return for the restrictive covenant being signed? Most states require an employee's agreement to noncompetition restrictions to be in exchange for receiving something of value, such as the initial job offer, a raise or promotion, or extra benefits upon leaving the organization.
- When will the noncompetition restriction be triggered? Some agreements apply automatically, whether the employee's termination was for cause, without cause, or as part of a layoff. Some agreements apply only if the employee resigns or is terminated for cause. Other agreements limit the period of restricted activity to the time severance benefits are being paid. Where the period of restricted activity is limited to the duration of severance benefit payments, the employee is free to forego severance payments to accept employment. Note that some employers include an agreed-upon fee that the employee will pay if the employee engages in the prohibited activity during the restricted period.

ENFORCEMENT

The best noncompete agreements are narrowly tailored to meet the most important needs of the organization, judiciously applied only to individuals in sensitive positions, and vigorously invoked when violated.

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In many cases, merely having a noncompete agreement in place will discourage most employees from leaving the organization to work for a competitor. When an employee does leave, however, the agreement allows the employer to have some control over the timing, terms, and effect of the departure. Companies must fight to enforce their noncompete agreements. If the potential harm is sufficient to justify a restrictive covenant, it is serious enough to do something about when that covenant is violated. Violation of noncompete agreements may allow employers to obtain, in addition to monetary damages, nonmonetary relief such as restraining orders and injunctions to protect the organization's interests. Companies that fail to enforce their noncompete agreements often find that their former employees' attorneys can argue that there was no need for the restriction in the first place since the organization has not bothered to enforce it in the past.

NONDISCLOSURE, NO-SOLICITATION, AND NO-RAID AGREEMENTS

Employers can have employees sign even more limited agreements — for example, nondisclosure, no-solicitation, and no-raid agreements — which do not limit their ability to work in the field but do prevent them from causing harm to the former employer in their new job. These more limited agreements are usually more easily enforced than a true noncompete agreement. One difficulty with these agreements, however, is proving they have been violated.

A nondisclosure agreement can prevent an employee from using or disclosing an employer's confidential information in the new job. An advantage of this sort of agreement is that the employer can define confidential information so that more things are included than would qualify as trade secrets under common law. In addition, such a signed agreement would prevent employees from pleading ignorance as an excuse for sharing confidential information. It would, of course, be difficult to prove a violation when the employer's confidential information could arguably be ascertained from sources other than the employee.

A no-solicitation agreement prohibits the employee from going after the organization's customers or suppliers. A no-raid agreement prohibits the employee and a new employer from inducing other employees to leave the original employer to work for the new one, at least for some specific time after the former employee leaves employment. While employee raiding is not recognized as a cause of action in most states, employers may be able to pursue a remedy for raiding of employees based on a claim of intentional interference with contractual relations or prospective economic advantage. These agreements tend to be viewed more favorably by the courts since they do not actually keep anyone from working.

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CONFLICT-OF-INTEREST CLAUSES

Many employers also include a conflict-of-interest clause in their noncompetition agreements. This provision generally requires employees to devote their entire productive time and full attention to the employer as a condition of employment. A conflict-of-interest clause may also contain an agreement by employees to refrain from directly or indirectly engaging in any outside employment, consulting, or other business activities while employed by the employer. Employees can additionally be required to agree to refrain from engaging in any outside employment without the written consent of the employer.

HIRING A COMPETITOR'S EMPLOYEES

Employers often find themselves in a position to hire a competitor's employees. In these cases, it is worthwhile to take some precautionary steps because state courts may find that a new employer's interference with valid noncompete agreements constitutes "tortious interference" with the former employer's relationship with the employee.

An employer should first determine if the employee is subject to any restrictions. An employer should not be satisfied with a vague answer to a question whether the employee has any sort of restrictive agreement with the former employer. The employer should have the employee sign a statement that the individual is not subject to any noncompete or other agreement. If an employer hires a competitor's employee knowing that the employee is subject to a restrictive covenant, the organization could be sued for interfering with the previous employer's contractual rights, just as employers could sue an organization that hired one of their employees subject to such an agreement.

The key to lawsuits regarding violation of another organization's restrictive covenant is the hiring organization's knowledge of the restriction and its decision to employ the person in spite of this knowledge. This is why the first step in such a case may be the sending of a certified letter by the old employer to the new, putting the new employer "on notice" of the restriction. If, in fact, it can be proven that the nature of an individual's work for the new employer makes it virtually impossible for the individual not to use or disclose the old employer's confidential information, a court may be persuaded to restrain the employee from working for the competition at all.

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If an employer learns that a new hire does have a restrictive covenant, the employer should obtain a copy of the restrictive covenant for legal counsel to examine. It may be that the prohibitive activity does not match the duties of the position to be filled. The agreement may also appear too broad. It may also be that there was no consideration in return for the agreement being signed.

Once an employer knows how enforceable the agreement is, the employer can decide how to proceed. An employer may want to begin negotiations with the other employer in cases where the agreement seems especially strong. The employer should be especially cautious about hiring employees with noncompetition agreements if the organization requires such agreements of its employees. It will be very difficult to enforce agreements, based on what the employer argues is a legitimate reason for having employees sign them, if an employer finds it acceptable to violate another employer's agreements.

EMPLOYER PRACTICES

Employers are protected by common law from the misuse of their trade secrets by former employees. To ensure their confidential information is protected, employers must actually treat this information as confidential and restrict access to it, instituting restricted-access procedures, and posting appropriate signs. Employees should be trained in the proper handling of confidential information.

In situations where employers fear that employees may leave and take customers with them or share crucial information with a new employer, employers should carefully draft appropriate restrictive covenants and have their employees sign them. Restrictive covenants must follow reasonable guidelines if there is to be any hope of enforcement. They must protect a legitimate interest of the employer and they must be as narrow as possible, avoiding broad and lengthy restrictions.

Employers are encouraged to limit disclosure of confidential information in the workplace by:

- Requiring employees to sign reasonable nondisclosure agreements and noncompete agreements where possible.
- Disseminating information on a need-to-know basis.
- Restricting access to file drawers and offices containing proprietary information.
- Developing and maintaining a sensible document retention and destruction policy.
- Conducting systematic inventories of confidential information.

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Furthermore, upon the departure of an employee with access to trade secret information, an organization should conduct an exit interview to obtain knowledge about the scope and duties of the employee's new position and to repossess or delete any trade secret information held by the employee (including home files).

Likewise, employers interviewing candidates should also take certain precautions to ensure that new employees do not become the subject of an injunction based on their former positions. Employers should first investigate whether a particular candidate is bound by a noncompete agreement or a nondisclosure agreement. If such an agreement(s) exists, the employer should obtain a written representation from the new employee that the employee complied with all obligations set forth within the agreement(s).

Employers also should be aware of a new employee's prior work product, which may be subject to "work for hire" limitations. As defined by the federal Copyright Act, work made for hire is, if the parties expressly agree in a written instrument signed by them that the work is considered a work made for hire, either of the following:

- A work prepared by an employee within the scope of their employment.
- A work specially ordered or commissioned for use as a contribution to a collective work or a compilation.

Limitations apply to such work due to the contractual agreements entered by the parties.

Finally, employers should remember to use practical methods to avoid the appearance of impropriety such as creating a new position for employees hired from competitors or documenting new employees' activities in ways that show independent action.

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