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Are Restrictive Covenants Alive Or Dead?

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The recent disputes between Hewlett-Packard Co. ("HP") and its former president and chief executive officer, Mark Hurd, have been the topic of much intrigue and public consumption. In addition, the publicity has prompted discussion of whether and under what circumstance restrictive covenants ("non-competes") and confidentiality agreements are enforceable. The answer to these questions depends on a multitude of factors and will vary with the applicable state law and facts. In New Jersey and New York, they are generally enforceable, if crafted properly.

HP v. Hurd

By way of background, Mr. Hurd resigned as CEO of HP in August 2010, after an investigation concluded that he violated HP's standards of business conduct in connection with his expense account filings. The backdrop of Mr. Hurd's resignation appears to have been in the context of an investigation of his alleged relationship with a former marketing contractor engaged by HP. Shortly thereafter, Oracle Corp., a business partner of HP, but also a rival in some areas, hired Mr. Hurd as co-president. Many HP stockholders and others questioned how an individual of Mr. Hurd's stature, depth of technical knowledge about HP and with a rich exit package, could be allowed to work for a competitor. Within 24 hours, HP filed a lawsuit seeking injunctive relief to preclude Mr. Hurd from joining Oracle.

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HP's lawsuit focused on confidentiality of trade secrets and alleged that Mr. Hurd's position as co-president and a member of the board of directors for Oracle put HP's trade secrets and confidential information in jeopardy. In addition, HP claimed that as a competitor, Mr. Hurd will necessarily call upon HP's trade secrets and confidential information in performing his duties for Oracle. Significantly, this dispute was based in California, where applicable state law prohibits non-competition agreements as a restraint of trade. California, however, does recognize trade secrets and, generally, the validity of reasonable confidentiality agreements.

Whether HP could have prevailed given the law in California prohibiting non-competition clauses and disfavoring "back-door" restraints will never be known. Just two weeks after the complaint was filed, the parties settled the dispute. Mr. Hurd agreed to waive his rights to valuable stock units worth nearly $14 million, and HP and Oracle issued a joint statement that Mr. Hurd would be able to perform his duties as co-president of Oracle while adhering to his obligations to protect HP's confidential information.

New York And New Jersey

As noted above, the enforceability of restrictive covenants is a function of state law. Several states, including California, have enacted laws to restrict or limit the use of such covenants. Thus, when parties are located in different states, the designated choice of law in the employment agreement is a critical issue governing the enforceability analysis.

In contrast, in New Jersey and New York, non-competes and agreements prohibiting solicitation of customers and employees ("non-solicits") can be enforceable with limited exceptions, such as the prohibition of non-competes in the New York broadcast industry. Such restrictions are generally enforceable if reasonable and narrowly tailored to be protective of the employer's legitimate business interests.

Similarly, confidentiality agreements, though generally recognized as valid in most jurisdictions, must be properly drafted. Employers should be careful to draft the definition of "confidential information" appropriately so that it includes trade secrets and proprietary information but is not overly broad. Equally important, employers should take steps to treat confidential information on a confidential basis, such as labeling it, using password-protected files, and restricting employee and third-party access to a "need to know" basis. If an employer does not attempt to protect its own confidential

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information, it will be in a weakened position to enforce its covenants.

Typically, an employer would seek to enforce such an agreement against a former employee who has subsequently become employed by a competitor. These lawsuits usually involve requesting emergent injunctive relief to prevent the employee from such competitive employment and/or to prevent solicitation of customers and/or employees. Although it is possible to file a complaint on a non-emergent basis, this approach is the exception rather than the rule in this area of law.

Frequently, the subsequent employer is named as a co-defendant based on such claims as tortious interference with contract. The success of this type of claim also depends upon state law and the extent to which the new employer was aware of the applicable restrictions and willfully disregarded them. If a defendant employer is adverse to becoming involved in litigation, the very filing of a lawsuit may result in the new employee's termination. On the flip side, all employers are advised to determine prior to hiring a new employee, especially from a competitor, if there are any prior covenants that limit or prevent a candidate's employment.

Courts addressing restrictive covenants analyze the enforceability of such agreements on a case-by-case basis, with close scrutiny of both the applicable language and the facts. In analyzing whether a provision is reasonable, courts generally weigh three factors. Competitive restrictions may be deemed reasonable if they (1) cover a geographic area in which the possible use of the trade secrets or customer knowledge will pose a substantial risk to the employer's business; (2) last for a period of time that will legitimately protect the employer and not impose undue hardship on the former employee; and (3) don't restrict competition in the specific type of business activity in which the employee was engaged.

In addition, courts commonly consider the position of the employee as well as the employee's access to trade secrets in analyzing enforceability. The reasonableness of a restriction may vary considerably by profession, industry and often position within the company. For example, sales, research/development and information technology positions have different considerations and may be subject to different analyses. It is generally recognized that in order for a covenant to be enforced, the employee must have had access to the employer's trade secrets, must have developed close relationships with customers, and must have performed services that are special or unique.

Where an employee is in a highly sensitive position and/or has a specific skill set with limited options for future employment, the employer may consider including an "on the beach" provision or severance by which an employee is effectively paid for a period of time in exchange for not competing with the company (provided he or she is not terminated for cause). Where the employee is being paid not to work for a competitor, courts generally deem the covenant enforceable.

In many states, including New Jersey, courts have recognized what is known as the "blue pencil rule," which means that the court has the right to modify a provision to some degree in order to make it reasonable in the court's view and, therefore, enforceable. New York also recognizes this rule, though arguably to a lesser extent. For example, if a geographic restriction is overbroad, a court may narrow the geographic scope to make it enforceable rather than invalidate the covenant. It is prudent to include a blue pencil provision in the agreement. Even if a jurisdiction generally recognizes the blue pencil rule, employers should not rely on same and overreach in drafting restrictive covenants given the different propensities of judges to enforce them.

Another issue involves whether there was adequate consideration to support the restriction in the first instance. It is generally accepted that the commencement of the employment relationship is sufficient legal consideration to support a restrictive covenant agreement as a matter of contract law. That leaves the question of whether current employees can be required to sign a restrictive covenant sometime during the course of the employment relationship and whether in that case the mere fact of "continued employment" is sufficient consideration to support the restrictions. The law both in New York and New Jersey supports the proposition that continued employment is valid consideration. From an enforceability standpoint, however, the best practice is to require employees to sign a restrictive covenant at the time of a promotion, salary increase or some other benefit, to ensure that there is additional consideration to support the restriction. Similarly, if a new covenant is entered at the time of separation of employment, the best case for enforceability will be if the covenant is supported by separate consideration.

Still other variables such as the court and assigned judge, even within the same state, can significantly affect the enforceability of non-competes and non-solicits. There is significant disparity between judges in their inclination to grant restraints on an employee's right to future employment.

Yet another variable is the employer's own conduct both during and after the employment relationship. For example, if the employer had an unfair course of dealing with the employee, this can weigh against enforceability. Another factor may be whether and under what circumstances the agreement can be enforced if the employee is terminated without cause. While there is no bright line rule in New Jersey or New York invalidating restrictive covenants in the event of termination without cause, some courts in weighing the equities analyze such covenants more strictly for reasonableness. The stronger case for supporting enforceability is when the employee has resigned voluntarily or was terminated for cause. The employee's own conduct may likewise be an issue. For example, if the employee breaches his/her fiduciary duty by starting to work for a competitor while still employed, few courts would not side with the employer.

Conclusion

The enforceability of restrictive covenants is a complicated area of law. When they are drafted, each provision should be analyzed on a case-by-case basis, considering such factors as the applicable state law, the employee's position within the company and his/her access to confidential information. We recommend consulting with experienced employment counsel when both drafting and seeking to enforce these covenants.