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"You're Fired! And Don't Forget Your Non-Compete . . .": The Enforceability of Restrictive Covenants in Involuntary Discharge Cases

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I. INTRODUCTION

Employment contracts that contain restrictive covenants rarely condition their enforceability on the method of separation. Indeed, most contracts are highly pro-employer, such that a covenant not to compete purports to take effect upon resignation or termination for any reason whatsoever. Most employers who seek to include a restrictive covenant in an employment agreement do so to prevent the unexpected resignation of a key executive or salesperson and the subsequent formation of a competing entity, which would be able to take advantage of client relationships or business know-how gained at the employer's expense. On the other hand, the vast majority of employers give comparatively less thought to the enforceability of the covenant in cases involving discharge, as opposed to those involving resignation. Initially, an employer may underestimate the threat a departed employee poses and may not realize the extent to which its client base or goodwill is threatened until the ex-employee starts competing. Because employment agreements are normally drafted in the employer's favor, a company official may examine the contract and believe that the covenant is enforceable against a discharged employee *regardless* of how the working relationship ended. The analysis, however, is not that simple. Strict considerations of fairness suggest that it is antithetical to allow an employer to terminate an employee *and* prevent him from working in his chosen profession. Moreover, the courts' traditional reluctance to enforce restrictive covenants,[2] in conjunction with the value that our society places on the free mobility of employees,[3] would seem to compel a court to invali-

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2. *See* Huntington Eye Assoc., Inc. v. LoCascio, 553 S.E.2d 773, 780 (W. Va. 2001) (stating that covenant is void on its face if it "appears designed to intimidate employees rather than protect the employer's business").

3. *See infra* Part III.

date a covenant in an involuntary discharge case. However, courts have not established any clear rules to provide judges, lawyers and parties with guidance in termination cases. The law in this area is relatively undeveloped, perhaps because so few termination cases have made their way through the reported decisions or the courts have not given them much reasoned analysis. Nevertheless, given the proliferation of restrictive covenants, especially considering *en masse* lay-offs and the fallout in the high-tech industry,[4] these issues are likely to arise with greater frequency, and the different approaches that courts have used are just as likely to confound litigants.

Following Part II, a brief overview of the law concerning restrictive covenants, Parts III.A., III.B., and III.C. analyze the current approaches courts have utilized in judging the enforceability of covenants in the involuntary termination context. Part III.D. explores how restrictive covenants have been addressed in other non-traditional employment separations, such as the expiration of an employment term contract, constructive discharge, and assignment of the contract to a business purchaser. Parts IV and V conclude with some practical advice for avoiding a costly legal dispute when an employer seeks to bind a discharged worker to a covenant not to compete.

II. BACKGROUND

While nineteen states regulate restrictive covenants by statute, the rest do so by common law.[5] In the employee context, restrictive covenants generally span four different areas: (1) general non-competition; (2) customer (or client) non-solicitation; (3) employee non-solicitation; and (4) non-disclosure. A brief overview of the general rules with respect to each type of covenant follows.

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4. *See* William Lynch Schaller, *Jumping Ship: Legal Issues Relating to Employee Mobility in High Tech. Indus.*, 17 LAB. LAW 25 (Summer 2001) (providing an excellent discussion of restrictive covenants in the information technology industry).

5. *See* ALA. CODE § 8-1-1 (2001); CAL. BUS. & PROF. CODE § 16600 (West 2002); COLO. REV. STAT. ANN. § § 8-2-113(2), 8-2-113(3) (West 2002); FLA. STAT. ANN. § 542.335 (West 2002); GA. CODE ANN. § 13-8-2.1 (2001); HAW. REV. STAT. ANN. § 480-4(c)(4) (Michie 2001); LA. REV. STAT. ANN. § 23:921 (West 2002); MICH. COMP. LAWS ANN. § 445.772 (West 2002); MONT. CODE ANN. § 28-2-703 (West 2002); NEV. REV. STAT. ANN. 613.200 (Michie 2002); N.C. GEN. STAT. § 75-4 (2002); N.D. CENT. CODE § 9-08-06 (2002); OKLA. STAT. ANN. tit. 15, § 217 (West 2002); OR. REV. STAT. § 653.295 (2002); S.D. CODIFIED LAWS § 53-9-11 (Michie 2002); TENN. CODE ANN. § 47-25-101 (2002); TEX. BUS. & COM. CODE ANN. § § 15.50-52 (Vernon 2002); W. VA. CODE § 47-18-3(a) (2002); WIS. STAT. ANN. § 103.465 (West 2002).

A. *Non-Competition Clauses*

Non-competition clauses seek to restrict an employee from working for a competitor upon departure and are carefully scrutinized by courts. Although the precise tests for governing the validity of a non-compete covenant vary from jurisdiction to jurisdiction, most states have adopted a modified version of Section 187 of the Restatement (Second) of Contracts and require that non-competition clauses be: (1) ancillary to a valid contract; (2) necessary to protect an employer's legitimate business interest; and (3) reasonable in terms of activity, duration and geographic scope.[6]

The doctrine of ancillarity is often met with ease, especially if the employee executes the restrictive covenant at the inception of the employment relationship, or upon a change in the employee's status, such as a promotion or significant pay raise.[7] Litigation on the ancillarity requirement frequently involves an employer's attempt to bind a current employee to a non-compete at some midpoint during the course of his employment, often threatening discharge if the employee refuses to cooperate.[8] Most states hold that, for at-will employees, continued employment constitutes sufficient consideration for the execution of a restrictive covenant,[9] although the reasoning varies among jurisdictions.[10] However, a minority of states, such as South

6. BDO Seidman v. Hirshberg, 712 N.E.2d 1220, 1223 (N.Y. 1999); Ellis v. James V. Hurson Assoc., Inc., 565 A.2d 615, 618-19 (D.C. 1989); Sidco Paper Co v. Aaron, 351 A.2d 250, 252 (Pa. 1976); TEX. BUS. & COM. CODE § 15.50(a) (Vernon 2002).

7. *See* Jostens, Inc. v. Nat'l Computer Sys., Inc., 318 N.W.2d 691, 703-04 (Minn. 1982) (holding that non-compete agreements lacked consideration because employer did not provide employees with future benefits, raises or promotions).

8. Comment "b" to the Restatement (Second) of Contracts § 187 provides, in part: "A promise made subsequent to the transaction or relationship is not ancillary to it. In the case of a continuing transaction or relationship, however, it is enough if the promise is made before its termination, as long as it is supported by consideration and meets the other requirements of enforceability." RESTATEMENT (SECOND) OF CONTRACTS § 187 cmt. b (1979). *Cf.* Tatge v. Chambers & Owen, Inc., 579 N.W.2d 217, 223-24 (Wis. 1998) (refusing to recognize cause of action for wrongful discharge based on employer's termination of employee for refusing to sign non-competition and non-disclosure agreement); Madden v. Omega Optical, Inc., 683 A.2d 386, 391 (Vt. 1996) (refusing to recognize cause of action for wrongful discharge based on employer's termination of employee for refusing to sign Confidentiality, Disclosure, and Noncompetition Agreement).

9. *See* Computer Sales Int'l, Inc. v. Collins, 723 S.W.2d 450, 452 (Mo. Ct. App. 1986) (holding continued employment is sufficient consideration for execution of restrictive covenant by at-will employee).

10. *See* Mattison v. Johnston, 730 P.2d 286, 290 (Ariz. Ct. App. 1986) (finding that employee's continued employment for a period of almost three months constituted sufficient consideration for execution of non-compete clause where *employee* terminated relationship); Cent. Adjustment Bureau, Inc. v. Ingram, 678 S.W.2d 28, 35 (Tenn. 1984) (holding whether consideration exists is a function of the length of employment following execution of restrictive covenant and the circumstances of the discharge); Thomas v. Coastal Indus. Servs., Inc., 108 S.E.2d 328, 329

Carolina and North Carolina, disagree and hold that other consideration must be provided to an at-will employee, rather than just continued employment.[11] A valid non-compete clause can be ancillary to other types of agreements, such as independent contractor agreements,[12] change-of-control agreements,[13] shareholder agreements,[14] settlement agreements,[15] lease agreements,[16] or as part of the sale of a business.[17] The ancillarity doctrine is more closely scrutinized in the traditional employment relationship, since the employee normally lacks bargaining power that may be present in these other business transactions. Non-compete litigation often focuses on whether the former employer is seeking to protect a legitimate business interest by restraining the departed employee from working in a similar position for a competitor.[18] It is widely agreed that "[a] covenant not to compete cannot be used to prevent competition *per se*;" rather, an employer must seek to protect a proprietary interest through its enforcement of the covenant.[19] What qualifies as a legitimate business interest varies from state to state, but customer relationships and trade secrets are the most widely recognized protectable interests.[20]

(Ga. 1959) (finding that consideration is furnished by actual performance of continued employment).

11. *See* Poole v. Incentives Unlimited, Inc., 548 S.E.2d 207, 209 (S.C. 2001) (holding continued employment not sufficient consideration for covenant not to compete) Kadis v. Britt, 29 S.E.2d 543, 548-49 (N.C. 1944) (same).

12. *See* Eichmann v. Nat'l Hosp. & Health Care Servs., Inc., 719 N.E.2d 1141, 1145 (Ill. App. Ct. 1999) (addressing non-competition covenant in independent contractor relationship).

13. *See* Szomjassy v. OHM Corp., 132 F. Supp. 2d 1041, 1048-50 (N.D. Ga. 2001) (addressing restrictive covenant in change-of control-agreement).

14. *See* Central Water Works Supply, Inc. v. Fisher, 608 N.E.2d 618, 622 (Ill. App. Ct. 1993) (equating non-competition clause in shareholder agreement with that incident to sale of business).

15. *See* Herndon v. The Eli Witt Co., 420 So. 2d 920, 923 (Fla. Dist. Ct. App. 1982) (addressing non-compete in settlement agreement); Justin Belt Co. v. Yost, 502 S.W.2d 681, 684 (Tex. 1974) (holding covenant not to compete entered as a result of an out-of-court settlement was valid and ancillary to a permissible transaction).

16. *See* J.C. Nichols Co v. Eddie Bauer, Inc., 4 F. Supp. 2d 875, 876 (W.D. Mo. 1998) (addressing restrictive covenant preventing sportswear retailer from operating additional stores within certain geographic area).

17. *See* Snow Country Const., Inc. v. Laabs, 989 P.2d 847, 849-50 (Mont. 1999) (holding that statutory exception allowing for covenant not to compete when the goodwill of a business has been sold applies equally to stock and asset sales).

18. *See* Katherine R. Schoofs, Comment, *Employer Beware: Missouri Puts Brakes on Interests Protected By a Restrictive* Covenant, 70 UMKC L. REV. 171 (Fall 2001) (discussing the scope of protectable interests).

19. Valley Med. Specialists v. Farber, 982 P.2d 1277, 1281 (Ariz. 1999).

20. *See* Easy Returns Midwest, Inc. v. Schultz, 964 S.W.2d 450, 453 (Mo. Ct. App. 1998) (holding that customer contacts and trade secrets are protectable interests of employer); Paramount Termite Control Co v. Rector, 380 S.E.2d 922, 925 (Va. 1989) (finding that customer contacts of former employees and knowledge of Paramount's methods of operation warrant the need for

Some states, such as Illinois, have refined the business interest test so that only "near-permanent" customer relationships qualify.[21] Other states, such as Utah, New York and Maryland, include unique services among legitimate business interests.[22] Kentucky, Pennsylvania and Georgia hold that employee training falls within the rubric of legitimate business interests,[23] while New Hampshire and Washington reject this theory and hold that an employer's interest in recouping the costs associated with "recruiting and hiring employees" is not protectable through a non-compete clause.[24] Florida and Tennessee recognize this interest, but with a distinction, by mandating that an employer must show "extraordinary or specialized training" before a restrictive covenant can be enforced.[25] Lastly, in Texas and Massachusetts, as well as many other states, goodwill is a protected employer interest.[26] With regards to the final requirement that covenants must be reasonable in scope, "scope" actually encompasses three factors: activity, duration, and geographical limit.[27] Some states, such as New Hampshire, Iowa and Texas, adopt the Restatement test

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non-competition agreements); Ridley v. Krout, 180 P.2d 124, 129 (Wyo. 1947) (stating that special facts that make a restrictive covenant reasonable include: possession of trade secrets, confidential information communicated by employer and special influence with customer obtained while employed).

21. *See* Office Mates 5, North Shore, Inc. v. Hazen, 599 N.E.2d 1072, 1080-1083 (Ill. App. Ct. 1992) (articulating near-permanency requirement).

22. *See* System Concepts, Inc. v. Dixon, 669 P.2d 421, 426 (Utah 1983) (holding that unique services of employee is protectable employer interest); Reed, Roberts Assocs. v. Strauman, 353 N.E.2d 590, 593 (N.Y. 1976) (same); Becker v. Bailey, 299 A.2d 835, 838 (Md. 1973) (same).

23. *See* Borg-Warner Protective Servs. Corp. v. Guardsmark, Inc., 946 F. Supp. 495, 500-02 (E.D. Ky. 1996) (protecting employer's interests in training and development costs of employees); Thermo-Guard, Inc. v. Cochran, 596 A.2d 188, 193-94 (Pa. Super. Ct. 1991) (same); Wesley-Jessen, Inc. v. Armento, 519 F. Supp. 1352, 1358 (N.D. Ga. 1981) (same).

24. *See* National Employment Serv. Corp. v. Olsten Staffing Serv., Inc., 761 A.2d 401, 405 (N.H. 2000) (rejecting employee training as protectable interest); Copier Specialists, Inc, v. Gillen, 887 P.2d 919, 920 (Wash. Ct. App. 1995) (holding that, in absence of other protectable interests, training of employee did not warrant enforcement of non-competition agreement).

25. *See* Hapney v. Cent. Garage, Inc., 579 So. 2d 127, 131 (Fla. Dist. Ct. App. 1991) (holding that "extraordinary or specialized training" is a legitimate employer interest), *rev'd on other grounds*, 579 So. 2d 127 (Fla. Dist. Ct. App. 1991); Vantage Tech., LLC v. Cross, 17 S.W.3d 637, 644-45 (Tenn. Ct. App. 1999) (stating that "employer may have a protectable interest in the *unique* knowledge and skill that an employee receives through special training by his employer, at least when such training is present along with other factors tending to show a protectable interest.").

26. *See* TEX. BUS. & COM. CODE § 15.50(a) (Vernon 2002) (including employer goodwill as protectable interest); IKON Office Solutions, Inc. v. Belanger, 59 F. Supp. 2d 125, 128 (D. Mass. 1999) (holding that goodwill of employer is a protectable interest, if employee cultivated his relationship with the client during his employment with the employer).

27. *See* Pinnacle Performance, Inc. v. Hessing, 17 P.3d 308, 311 (Idaho Ct. App. 2001) (noting parameters of reasonableness inquiry); UARCO Inc. v. Lam, 18 F. Supp. 2d 1116, 1121 (D. Haw. 1998) (same).

to determine reasonableness and examine three factors: (1) whether the restriction is greater than necessary to protect the business and goodwill of the employer; (2) whether the employer's need for protection outweighs the economic hardship which the covenant imposes on the departing party; and (3) whether the restriction adversely affects the interests of the public.[28] If a court determines that a non-compete is overbroad in terms of a durational[29] or geographic[30] limit, then most will modify them, either under a reasonableness standard[31] or the "blue-pencil" doctrine,[32] so that they are narrowly tailored to protect the employer's interest. A minority group of states, including Nebraska and Arkansas, reject both modification doctrines and will void overbroad covenants.[33]

B. *Customer Non-Solicitation Covenants*

A customer, or client, non-solicitation covenant is an activity restraint. Put another way, it does not prevent an employee from working for a competitor, but only prohibits the solicitation of a former employer's clients.[34] Because these covenants do not restrain an em-

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28. RESTATEMENT (SECOND) OF CONTRACTS § 188 (1979); *Olsten Staffing*, 761 A.2d at 403; Phone Connection, Inc. v. Harbst, 494 N.W.2d 445, 449 (Iowa Ct. App. 1992); Peat Marwick Main & Co. v. Haass, 818 S.W.2d 381, 386 (Tex. 1991); *see also* Harlan M. Blake, *Employee Agreements Not to* Compete, HARV. L. REV. 625, 648-49 (1960) (stating three-pronged rule of reason inquiry).

29. *See* Ferrofluidics Corp. v. Advanced Vacuum Components, Inc., 968 F.2d 1463, 1469 (1st Cir. 1992) (upholding district court's revision of non-compete clause from five to three years). *But see* Stone v. Griffin Communications & Sec. Sys., Inc., 53 S.W.3d 687, 696 (Tex. Ct. App. 2001) (upholding five-year covenant not to compete as a reasonable time restriction), *rev'd on other grounds*, 71 S.W.3d 381 (Tex. App. 2001).

30. *See* Camco, Inc. v. Baker, 936 P.2d 829, 833-34 (Nev. 1997) (holding that territorial restriction of fifty miles was overbroad since it extended beyond area where employer established customer contacts and goodwill); Smart Corp. v. Grider, 650 N.E.2d 80, 84-85 (Ind. Ct. App. 1995) (modifying covenant not to compete so that employee was restrained only from doing business in area where she developed and serviced clients). *But see* Kimball v. Anesthesia Specialists of Baton Rouge, Inc., 809 So. 2d 405, 409-12 (La. Ct. App. 2001) (refusing to enforce covenant not to compete when no specific parish or municipality was delineated as geographical restriction under state statute requiring such specificity).

31. *See* Data Mgmt., Inc. v. Greene, 757 P.2d 62, 64-65 (Alaska 1988) (rejecting "blue-pencil" doctrine as too "mechanical" and modifying covenant not to compete under "rule of reasonableness" so that legitimate interest of employer is protected).

32. *See* Licocci v. Cardinal Assocs., Inc., 432 N.E.2d 446, 452 (Ind. Ct. App. 1982) (using "blue-pencil" doctrine to delete offending provisions of restrictive covenant), *vacated on other grounds*, 445 N.E.2d 556 (Ind. 1983).

33. *See* CAE Vanguard v. Newman, 518 N.W.2d 652, 655-56 (Neb. 1994) (rejecting court modification of covenants); Rector-Phillips-Morse, Inc. v. Vroman, *489* S.W.2d 1, 4 (Ark. 1973) (holding that the court will not reduce the restriction to a shorter time or smaller area; thus making a new contract).

34. *See* Merrill Lynch, Pierce, Fenner & Smith Inc. v. Ran, 67 F. Supp. 2d 764, 774 (E.D. Mich. 1999) (upholding as reasonable a one-year customer "anti-piracy" clause).

ployee from pursuing a particular line of work, they are far less likely to be invalidated in a judicial proceeding. Just as is the case with more restrictive non-competes, customer non-solicitation clauses are judged by a standard of reasonableness and are usually upheld when the employer enabled the employee to develop lasting customer contacts and when the covenant is tailored to protect that interest.[35] Conversely, a court is likely to invalidate a customer non-solicitation covenant that prohibits an employee from soliciting clients or customers with whom he had no contact or business relationship.[36] In Illinois, for instance, non-solicitation clauses are not valid for every type of salesperson. An employer must still show that the customer relationship sought to be protected is "near-permanent," which does not allow an employer to prevent solicitation if the sales function involves "cold-calling," if there is relatively little customer loyalty, or if the good or service provided is fungible.[37]

C. *Employee Non-Solicitation Covenants*

With one startling exception, employee non-solicitation covenants have met with relatively little judicial resistance, as courts have held that it is reasonable for an employer to protect its investment in training its staff and maintaining a competent workforce.[38] Nevertheless, they are still strictly construed against the drafting party and will not preclude a party from hiring a competitor's employees if such passive solicitation is not expressly prohibited.[39] Some states will even void an employee non-solicitation covenant that bars the mere hiring of an

35. *See* Corson v. Universal Door Sys., Inc., 596 So. 2d 565, 568-69 (Ala. 1991) (emphasizing importance of employer's role in introducing employee to key customers).

36. *See* Hulcher Servs., Inc. v. R.J. Corman R.R. Co., 543 S.E.2d 461, 467 (Ga. Ct. App. 2000) (holding that employer had no protectable interest in preventing employee from soliciting customers that employee did not know on professional level).

37. *See* Dam, Snell & Teveirne, Ltd. V. Verchota, 754 N.E.2d 464, 469-70 (Ill. App. Ct. 2001) (employing same "near-permanency" test for non-solicitation clauses); Henri Studio, Inc. v. Outdoor Mktg., Inc., No. 96 C 8198, 1997 WL 652351, at *4 (N.D. Ill. Oct. 14, 1997) (finding no "near-permanent" customer relationship in sales-driven business; emphasizing that customer names were readily available and accessible; customers attended trade shows where plaintiff's competitors were present; sales were based on individual purchase orders; no exclusivity agreements; customers purchased goods from multiple manufacturers); Office Mates 5, North Shore, Inc. v. Hazen, 599 N.E.2d 1072, 1082-86 (Ill. App. Ct. 1992) (involving account executives with office support personnel placement agency where names of businesses with needs were well-known, clients used many placement agencies; cold-calling was common; fifty percent of clients never returned and two-thirds of clients had less than a three-year relationship).

38. *See* Balasco v. Gulf Auto Holding, Inc., 707 So. 2d 858, 860 (Fla. Dist. Ct. App. 1998) (noting importance of workforce stability).

39. *See* Atmel Corp. v. Vitesse Semiconductor Corp., 30 P.3d 789, 793 (Colo. Ct. App. 2001) (examining custom of semiconductor industry to hold that only "active" solicitation was prohibited); Warner & Co. v. Solberg, 634 N.W.2d 65, 73 (N.D. 2001) (upholding employee non-solici-

employee, as opposed to more active, aggressive efforts to recruit away key talent.[40]

Missouri courts take an altogether different approach, holding that a former employee's covenant not to solicit or encourage other employees to terminate their employment is void as an unenforceable restraint of trade.[41] The reasoning behind this rather unique rule is that an employer's interest in its at-will employees, or their skills, is not a proprietary interest worthy of protection through a restrictive covenant.[42] It remains to be seen whether Missouri's approach will be adopted in other states.

D. *Non-Disclosure Covenants*

The final category of restrictive covenants, non-disclosure agreements, has proven to be even less problematic than employee non-solicitation covenants. Employee confidentiality clauses are almost always upheld if they are reasonable, but some courts have invalidated, or modified, clauses that are clearly overbroad in terms of the type of information they seek to prevent from disclosure.[43] Even in the absence of a confidentiality agreement, an employee may be bound not to disclose proprietary information as a common law duty.[44] The real value of such agreements for an employer is two-fold: (1) to identify and prevent from disclosure certain business-specific categories of information that may not otherwise qualify as a trade secret;[45] and (2) to provide for liquidated damages in the event of disclosure.[46]

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tation covenant which was "narrowly drawn" to penalize only active solicitation by departed employee).

40. *See* Loral Corp. v. Moyes, 219 Cal. Rptr. 836, 841-43 (Cal. Ct. App. 1985) (holding that hiring prohibition is void under Section 16600 of Business and Professions Code).

41. Schmersahl, Treloar & Co., v. McHugh, 28 S.W.3d 345, 351 (Mo. Ct. App. 2000).

42. *Id.* at 350-51.

43. *See* Trailer Leasing Co. v. Assocs. Commercial Corp., No. 96 C2305, 1996 WL 392135, at *6 (N.D. Ill. July 10, 1996) (holding that agreement barring employee from disclosing "any methods or manners" of business was unenforceable); Nasco, Inc. v. Gimbert, 238 S.E.2d 368, 369-70 (Ga. 1977) (holding that non-disclosure covenant barring use or disclosure of "any information concerning any matters affecting or relating to the business of employer" was overbroad and unenforceable).

44. *See* Anderson Chem. Co. v. Green, 66 S.W.3d 434, 442 (Tex. Ct. App. 2001) (imposing duty on employee under common law not to disclose employer's confidential information).

45. *See* Bernier v. Merrill Air Eng'rs, 770 A.2d 97, 103 (Me. 2001) (holding that confidential information protected under agreement need not be limited to trade secrets under Maine's version of Uniform Trade Secrets Act).

46. *See* Overholt Crop Ins. Co. v. Travis, 941 F.2d 1361, 1369-70 (8th Cir. 1991) (stating that, under either South Dakota or Minnesota law, liquidated damages of twice the amount of premiums lost by insurance agency were reasonable estimate of damages that were difficult to calculate following breach of non-solicitation and non-disclosure covenants).

III. ANALYSIS

Although all types of restrictive covenants are judged by a standard of reasonableness, the question remains as to whether it is reasonable to enforce a covenant not to compete when an employee is terminated. The answer, according to the reported judicial decisions, is anything but clear. Sections A, B and C describe the judicial treatment given to restrictive covenants in cases where an employer discharges an employee. Following this summary of the judicial rules developed in termination cases, Section D will examine restrictive covenants in those employment separations that do not fit neatly into the categories of either resignation or termination.

A. *Non-Competition Covenants*

Courts have taken three approaches to analyzing whether general non-competition clauses are enforceable in discharge cases. The first, as forcefully articulated by New York courts, holds that such covenants are *per se* invalid when the employer discharges the employee without cause.[47] The second line of cases, representing the majority position, adopts a middle ground; rather than creating a *per se* rule in favor of either an employee or employer, these courts require a 'plus factor' to determine enforceability and normally examine the nature of the employer's conduct in effectuating the termination.[48] In Pennsylvania, for instance, a non-compete is presumptively invalid in a termination case, but can be enforced in certain circumstances where a protectable interest is threatened.[49] In many states, such as Minnesota, Massachusetts and Texas, courts examine whether the termination was conducted arbitrarily or in bad faith.[50] Other states, such as South Dakota and Missouri, give the trial judge the discretion to consider the involuntary nature of the discharge in a flexible balancing the equities approach.[51] The third and final analysis, which only the Florida courts have adopted so far, is decidedly pro-employer and holds that a court cannot consider an involuntary termination in determining the enforceability of a non-compete clause.[52]

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47. *See infra* Part III.A.1 (addressing cases holding that covenant is *per se* invalid).

48. *See infra* Part III.A.2 (analyzing the middle ground – presumption against enforcement, bad faith, or balancing the equities approach).

49. *See infra* Part III.A.2.a (examining the presumption against enforcement approach).

50. *See infra* Part III.A.2.b (examining bad faith cases and the employer-focused approach).

51. *See infra* Part III.A.2.c (discussing cases employing the balancing the equities analysis).

52. *See infra* Part III.A.3 (analyzing cases which hold that discharge is not a factor to consider).

1. Cases Holding That Covenant Is *Per Se* Invalid

Only one jurisdiction has adopted a bright-line, pro-employee view on enforcing non-competition clauses in termination cases. New York courts have articulated a *per se* rule, such that an employee who is terminated without cause is not bound by a non-compete clause. In *Post v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,[53] the New York Court of Appeals examined the enforceability of non-competition clauses that applied to a group of employees who had been terminated without cause from Merrill Lynch. Merrill Lynch's pension plan had a "forfeiture-for-competition" clause, which denied employees their pension benefits if they competed with the firm after departure.[54] The Court, in broad language, held that the covenants were void, and the employees' pension benefits could not be forfeited.[55] In so holding, the Court stated:

> An essential aspect of [the employment relationship] . . . is the employer's willingness to employ the party covenanting not to compete. Where the employer terminates the employment relationship without cause, however, his action necessarily destroys the mutuality of obligation on which the covenant rests as well as the employer's ability to impose forfeiture.[56]

The analysis used in *Post* is limited to those cases in which an employee has been terminated without cause. In subsequent New York decisions, courts have routinely applied *Post* to involuntary terminations without cause and have struck down non-competes as invalid *per se*.[57] The logical corollary to this rule, of course, is that terminations for cause are not included, and that the restrictive covenants would not be invalidated on this basis.

The New York courts made this for cause/without cause distinction in two recent federal cases, *Gismondi, Paglia, Sherling, M.D., P.C. v. Franco*[58] and *Cray v. Nationwide Mutual Ins. Co.*[59] In these cases, the courts held that *Post* does not apply when an employee violates his employment contract and is terminated for cause.[60] In *Franco*, the

53. Post v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 397 N.E.2d 358 (N.Y. 1979).

54. *Id.* at 359.

55. *Id.* at 360-61.

56. *Id.*

57. SIFCO Indus., Inc. v. Advanced Plating Techs., Inc., 867 F. Supp. 155, 158-59 (S.D.N.Y. 1994).

58. Gismondi, Paglia, Sherling, M.D., P.C. v. Franco, 104 F. Supp. 2d 223 (S.D.N.Y. 2000).

59. Cray v. Nationwide Mut. Ins. Co., 136 F. Supp. 2d 171 (W.D.N.Y. 2001).

60. *See* Cray, 136 F. Supp. 2d at 179; *Franco*, 104 F. Supp. 2d at 233; *see also* Adrian N. Baker & Co. v. Demartino, 733 S.W.2d 14, 18-19 (Mo. Ct. App. 1987) (enforcing covenant not to compete when discharge of employee occurred with good cause); Patterson Int'l Corp. v. Herrin, 25 Ohio Misc. 79, 85 (Oh. Ct. Comm. Pl. 1970).

court found that the defendant was in fact terminated for cause since he failed to turn over hospital payments to his professional corporation, failed to promote the medical practice, misappropriated billing records, and committed a host of other acts in contravention of his employment contract.[61] In *Cray*, the court found that there was a genuine issue of material fact as to whether the insurance agent, an independent contractor, breached his agency agreement and was terminated for cause by misappropriating trade secrets, engaging in unauthorized brokering for third parties, and attempting to induce policyholders to switch to different companies.[62]

2. The Three Middle-Ground Analyses

The majority of cases do not go as far as the New York courts in terms of protecting employees and, by extension, the free mobility of labor. The middle-ground cases hold that a non-compete clause is: (1) presumptively invalid in an involuntary discharge situation; (2) invalid if an element of bad faith in the termination is present; or (3) invalid if the trial judge finds that equitable considerations militate against enforcement of the covenant. Adding confusion to the myriad rules developed in termination cases, one jurisdiction – Illinois – which started out as a 'bad faith' state, but has since migrated towards a categorical analysis, similar to that set forth in *Post.*

a. Presumption Against Enforcement

The Superior Court of Pennsylvania in *Insulation Corp. of America v. Brobston*[63] articulated a pro-employee rule that creates a presumption against enforcing non-competition clauses in termination cases. Brobston worked for a company called ICA, which was engaged in the manufacture and sale of polystyrene packaging, roofing and insulation products.[64] Brobston worked for ICA in several different capacities before being promoted to general manager in 1990.[65] In 1992, ICA expanded its product line to include more specialized products through the use of a computer-assisted design (CAD) system.[66] ICA required Brobston and other employees to execute employment contracts containing restrictive covenants.[67] Shortly thereafter, Brob-

61. *Franco*, 104 F. Supp. 2d at 233.
62. *Cray*, 136 F. Supp. 2d at 176.
63. Insulation Corp. of Am. v. Brobston, 667 A.2d 729 (Pa. Super. Ct. 1995).
64. *Id.* at 731.
65. *Id.*
66. *Id.*
67. *Brobston*, 667 A.2d at 731-32.

ston's work performance deteriorated.[68] He failed to file sales calls and expense reports, and only three of his fourteen accounts showed growth.[69] The following year, ICA terminated Brobston's employment.[70] Brobston subsequently found employment with an ICA competitor.[71]

The court addressed the issue of Brobston's termination in the overall reasonableness context. In its opinion, striking the non-compete as void, the court stated:

> Where an employee is terminated by his employer on the grounds that he has failed to promote the employer's legitimate business interests, it clearly suggests an implicit decision on the part of the employer that its business interests are best promoted without the employee in its service. The employer who fires an employee for failing to perform in a manner that promotes the employer's business interests deems the employee worthless. Once such a determination is made by the employer, the need to protect itself from the former employee is diminished by the fact that the employee's worth to the corporation is presumably insignificant. Under such circumstances, we conclude that it is unreasonable as a matter of law to permit the employer to retain unfettered control over that which it has effectively discarded as worthless to its legitimate business interests.[72]

Brobston suggests that a non-compete clause is presumptively invalid when an employer terminates the employee. The court stated that "[t]his conclusion would remain the same even if it were determined that Brobston was legitimately terminated for economic reasons . . . where an employer determines that its 'bottom-line' is best protected without the employee on the payroll. However, it must be kept in mind that reasonableness is determined on a case-by-case basis."[73]

It is clear that the *Brobston* court believed that an economically motivated reduction-in-force would not allow an employer to enforce a non-compete clause.[74] Along the same lines, not all terminations for performance deficiencies, or disagreements between employer and employee, can be classified as terminations for cause, and frequently, employment contracts expressly define what "for cause" means.[75] Regardless, Brobston's termination, even considering his poor perform-

68. *Id.* at 732.
69. *Id.*
70. *Id.*
71. *Brobston*, 667 A.2d at 732.
72. *Id.* at 735.
73. *Id.* at 735 n.6.
74. *Id.*
75. *See* Nairn v. Bartusiak, 29 Pa. D & C.4th 373, 383 (Pa. C.P. 1995) (holding agreement provided that covenant not to compete would be enforced if employee was terminated with

ance, was likely not for cause. *Brobston* appears to hold that terminations *without cause* raise a strong presumption against enforceability of a non-competition covenant.[76]

However, the court never made this perfectly clear. Apparently, the dissent recognized their omission when Judge Del Sole stated: "what is to prevent a salesperson, who has secretly been recruited by a competitor, from purposely trying to be terminated rather than resigning and then working for the competitor free of the constraints of the restrictive covenant[?]"[77] In such an extreme case, the Pennsylvania courts would likely seize upon the language in footnote 6, which states that reasonableness is always determined on a case-by-case basis.[78] Cases of material breach of job duties, fraud, and breach of fiduciary duty would likely fall within the court's limited reasonableness exception.

This exception did arise in *Hess v. Gebhard & Co.*,[79] which involved the termination of an insurance salesman after a corporate purchase. In that case, Gebhard, the corporate acquirer of Hoaster's insurance business, notified Hess that his employment as a servicer of insurance accounts would cease on December 31, 1996.[80] However, Gebhard did give Hess two options for alternative employment, for which Hess ultimately believed he was not qualified.[81] Prior to notifying Gebhard of his disinterest in either position, Hess negotiated with a competitor and solicited Gebhard clients for his new firm.[82] The court noted the *Brobston* ruling, but stressed that reasonableness must be determined on a case-by-case basis.[83] Deeming it important that Hess was not "worthless" to Gebhard, the court held that the covenant not to compete would be enforced.[84]

Since *Brobston* makes it fairly clear that an economically motivated discharge, such as that effectuated by a corporate purchase, would void a non-compete,[85] it seems likely that the ruling in *Hess* had more

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cause, but that employer's frustration with employee's work performance and inability to reach an agreement to form a partnership did not fall within this provision; invalidating non-compete).

76. *Cf.* Horizons Res., Inc. v. Troy, No. CIV.A.14740, 1995 WL 761214 at *5 (Del. Ch. Dec. 21, 1995) (upholding non-compete clause, but stating "[t]his is not a case in which defendants were fired by plaintiff and plaintiff then tried to stop them from finding other employment.").

77. *Brobston*, 667 A.2d at 739 (Del Sole, J., dissenting).

78. *Id.* at 735 n.6.

79. Hess v. Gebhard & Co., 769 A.2d 1186 (Pa. Super. Ct. 2001).

80. *Id.* at 1189.

81. *Id.*

82. *Id.*

83. *Hess*, 769 A.2d at 1192.

84. *Id.*

85. *See Brobston*, 667 A.2d at 735 n.6.

to do with Hess' pre-termination competitive activities and his failure to notify Gebhard that he would not accept a new position prior to the time he solicited clients. In light of *Hess*, it is doubtful that Pennsylvania courts will go as far as New York courts in terms of protecting a discharged employee. The rule of reasonableness certainly gives courts some flexibility.

One commentator posits that the Pennsylvania cases can be read in such a way that courts will invalidate non-competition clauses if the reasons for involuntary discharge do not relate directly to the interests the employer seeks to protect through the covenant.[86] Applying this theory to practice, the limited situations in which an employer's termination relates directly to a protectable interest, such as pre-termination theft of trade secrets or solicitation of customers, almost certainly would justify a termination for cause. As such, *Brobston*, as a practical matter, may be quite close to *Post*, which clearly conditions enforceability of a non-compete on whether the employee was terminated for cause. In fact, Pennsylvania courts arguably may be even more protective of employees in discharge cases, since some terminations, such as insubordination, may be for cause, but unrelated to the employer's protectable interest. Without further interpretation of *Brobston*, it remains to be seen how this rule will apply in practice.

b. The "Bad Faith" Analysis

i. *Rao v. Rao* and the Illinois Cases

In *Rao v. Rao*,[87] the Seventh Circuit, interpreting a novel issue of Illinois law, held that an employee who is discharged without cause *and* in bad faith could not be limited by a non-competition clause in his employment contract.[88] In that case, Mohan, a thoracic and cardiovascular surgeon, was the sole owner, officer and director of a medical service corporation.[89] Hari began working at Mohan's corporation in 1976 and signed a term employment contract, renewable from year-to-year, which contained a non-compete clause.[90] The agreement provided that, at the end of four years of service, Hari would be able to purchase fifty percent of Mohan's corporation for a

86. *See* Kurt H. Decker, *Refining Pennsylvania's Standard for Invalidating a Non-Competition Restrictive Covenant When an Employee's Termination Is Unrelated to the Employer's Protectible Business Interest*, 104 Dick. L. Rev. 619 (Summer 2000) (addressing Pennsylvania courts' treatment of covenants in involuntary discharge cases).

87. Rao v. Rao, 718 F.2d 219 (7th Cir. 1983).

88. *Id.* at 224.

89. *Id.* at 221.

90. *Id.*

nominal sum.[91] On December 21, 1979, just prior to the time that Hari's option to become a part-owner of the business vested, Mohan sent a letter notifying Hari of his intent to terminate the employment relationship.[92] Hari began competing, and Mohan sued for enforcement of the non-compete clause or, in the alternative, liquidated damages.[93]

The trial court found that Hari's work performance was satisfactory, and that he was terminated because Mohan did not want him to exercise his contractual right to obtain a fifty percent interest in the corporation.[94] The appellate court affirmed the trial court's refusal to enforce the non-compete.[95] In so holding, the Seventh Circuit first noted that, under Illinois law, "in every contract both parties promise to act in good faith."[96] With this premise established, the court stated that "[t]he implied promise of good faith . . . modifies [Mohan's] discretionary right to dismiss Hari and then to invoke the restrictive covenant."[97] The court held that Mohan could not enforce the covenant, whether it analyzed the implied duty of good faith as an independent contractual term, or whether a "good faith termination is a condition precedent to the operation of the restrictive covenant."[98] Under either analysis, the result was the same: a bad faith termination will not allow an employer to obtain the benefit of a restrictive covenant.[99]

The court's analysis, however, was somewhat unclear. In *dicta*, the court seemed to shy away from a *per se* rule similar to that articulated in *Post*, when it stated that "[t]o be sure, there are cases where an employer dismisses an employee but the *employee's* inadequate per-

91. *Rao*, 718 F.2d at 221.
92. *Id.*
93. *Id.*
94. *Id.* at 222.
95. *Rao*, 718 F.2d at 222.
96. *Id.* (citing Osten v. Shah, 433 N.E.2d 294, 296 (Ill. App. Ct. 1982)).
97. *Id.* at 223. It is fairly clear that a *wrongful* termination, that is, one that is in breach of contract, will relieve an employee from a restrictive covenant. *See* Washington County Mem'l Hosp. v. Sidebottom, 7 S.W.3d 542, 546 (Mo. Ct. App. 1999) (stating that employer who materially breaches employment agreement cannot enforce restrictive covenant against employee); Bergstein v. Tech. Solutions Co., 654 N.E.2d 479, 480-81 (Ill. App. Ct. 1995) (stating that involuntary discharge roughly one year prior to expiration of term contract relieved employee from restrictive covenant obligations); Ward v. Am. Mut. Liab. Ins. Co., 443 N.E.2d 1342, 1343-44 (Mass. App. Ct. 1983) (holding that employer's breach of contract voids non-compete clause). Additionally, if an employer breaches an employment agreement and an employee subsequently resigns to start competing, the employer's material breach of the employment contract will serve as a valid defense to enforcement. *See* Francorp, Inc. v. Siebert, 126 F. Supp. 2d 543, 547 (N.D. Ill. 2000) (stating that former employer's failure to pay departed executives' salary for several weeks necessitated their departure and excused them from non-compete obligations).
98. *Rao*, 718 F.2d at 223.
99. *Id.*

formance, in fact, impelled the dismissal."[100] In such a case, the *Rao* court stated that "a restrictive covenant may be as reasonably necessary as in the cases where the employee voluntarily leaves his job."[101] Nevertheless, the *Rao* court went on to state that "a restrictive covenant that can become effective when an employee is terminated without good cause is not reasonably necessary to protect an employer's goodwill."[102] Although this last statement could conceivably be interpreted as a categorical rule against enforcement, this is most likely not what the *Rao* court intended, given its focus on the employer's conduct and its concern with the employee's job performance.

The Illinois Appellate Court muted the *Rao* bad faith analysis in *Bishop v. Lakeland Animal Hospital, P.C.*[103] In the *Bishop* case, neither party disputed the fact that the plaintiff, who had a four-year non-competition clause in her employment contract, was terminated without cause. The court agreed with the reasoning in *Rao* and held that the implied promise of good faith inherent in every contract precluded enforcement of the non-compete clause when the employer terminated the employee without cause. The *Bishop* court did not mention the *dicta* in *Rao,* which cautions against a categorical rule.[104] In fact, *Bishop* can certainly be read as setting forth such a categorical rule, since the court states that "in order for a noncompetition clause to be enforceable . . . the employee must have been terminated for cause or by his own accord."[105]

No Illinois case since *Bishop* has clarified this tension definitively. However, in *Francorp, Inc. v. Siebert*, the court appeared to confirm the notion that *Bishop* did create a *per se* rule along the lines of *Post.*[106] After first discussing the bad faith rule articulated in *Rao*, the *Siebert* court stated that *Bishop "takes the rule farther*, holding that an employer cannot enforce a noncompetition agreement against an employee who has been dismissed without cause, even if the employment contract authorizes such termination, because firing without cause breaches the implied covenant of good faith inherent in every con-

100. *Id.* at 224.

101. *Id.*

102. *Rao,* 718 F.2d at 224.

103. Bishop v. Lakeland Animal Hosp., P.C., 644 N.E.2d 33 (Ill. App. Ct. 1994).

104. *Id.* at 34-35 (agreeing with the reasoning employed by the seventh circuit and concluding that when the employer dismisses the employee without cause, the implied promise of good faith that is found in every contract precludes enforcement of a noncompetition clause).

105. *Id.*

106. *Siebert,* 126 F. Supp. 2d at 546.

tract."[107] While Illinois once appeared to be in the 'bad faith' camp, it now advocates a pro-employee *per se* rule.[108]

However, the reasoning of the Illinois cases is curious at best.[109] Reading *Siebert's* interpretation of *Bishop*, the *Siebert* court seems to hold that any termination without cause, *even if* authorized by the employment contract, breaches the implied covenant of good faith and fair dealing.[110] This seems to constitute an almost untenable proposition, because if taken literally, it would create a cause of action for every employee who is fired without cause, which is something that Illinois courts have refused to hold.[111] What the court in *Siebert* may have meant is that an employer's attempt to enforce a non-compete clause, after discharging an employee without cause, amounts to bad faith and, concomitantly, gives rise to an affirmative defense against enforcement. However, it is more likely that the *Siebert* court tried in vain to reconcile the bad faith language in *Rao* with *Bishop*'s extension of the rule. It would have been less confusing if the court just declared that termination without cause precludes enforcement of a covenant not to compete, as a matter of law, for that is clearly how *Bishop* reads.

ii. Other 'Bad Faith' Cases and the Employer-Focused Approach

Several other jurisdictions follow the reasoning set forth in *Rao* and focus on the employer's conduct in carrying out the termination to determine the enforceability of a covenant not to compete. For instance, the Supreme Court of Wyoming, in *Hopper v. All-Pet Animal Clinic, Inc.*,[112] held that "[s]imple justice requires that a termination by the employer of an at will employee be in good faith if a covenant not to compete is to be enforced."[113] Although finding that the employer's conduct in terminating the plaintiff was not in bad faith, the

107. *Id.* (emphasis added).

108. *Id.*

109. *Cf.* Woodfield Group, Inc. v. DeLisle, 693 N.E.2d 464, 469 (Ill. App. Ct. 1998) (suggesting that employer's termination of employee may affect whether continued employment is sufficient consideration for at-will employee's execution of non-compete clause); Simko, Inc. v. Graymar Co., 464 A.2d 1104, 1107-08 (Md. Ct. Spec. App. 1983) (same).

110. *Siebert*, 126 F. Supp. 2d at 546. *Contra* Schwartz v. Fortune Magazine, 89 F. Supp. 2d 429, 434 (S.D.N.Y. 1999) (holding that, under New York law, where contract permits termination without cause, court does not inquire into claimed "bad faith" motivations for termination, but rather determines whether party's actions in terminating the contract are consistent with termination provisions).

111. *See* Harrison v. Sears, Roebuck & Co., 546 N.E.2d 248, 255-56 (Ill. App. Ct. 1989) (declining to give employee cause of action for breach of implied covenant of good faith and fair dealing in at-will setting).

112. Hopper, D.V.M. v. All Pet Animal Clinic, Inc., 861 P.2d 531, 541 (Wyo. 1993).

113. *Id.* at 541.

Hopper court did give an example of what conduct might militate against enforcement of a restrictive covenant. Specifically, the *Hopper* court noted that a covenant might be void "if an employer hired an employee at will, obtained a covenant not to compete, and then terminated the employee, without cause, to arbitrarily restrict competition."[114]

Both Tennessee and Mississippi follow the Wyoming approach and judge the overall reasonableness of the covenant through consideration of the nature of the dismissal. For instance, in *Central Adjustment Bureau, Inc. v. Ingram*,[115] the Tennessee Supreme Court stated that "[a]lthough an at-will employee can be discharged for any reason without breach of contract, a discharge which is arbitrary, capricious or in bad faith clearly has a bearing on whether a court of equity should enforce a non-competition covenant."[116] The Supreme Court of Mississippi, in *Empiregas, Inc. v. Bain*,[117] used an identical test.[118] Similarly, Minnesota courts will not enforce restrictive covenants against discharged employees where the employer has taken "undue advantage" of its right to terminate,[119] or where the employer's conduct was "unconscionable" by reason of a "bad motive."[120] Similar to the court's analysis in *Rao*, these courts examine the employer's conduct and the motives behind the discharge, but not necessarily its effect on the employee.

Indiana courts took a similar approach in *Gomez v. Chua Medical Corp.*,[121] holding that "[w]here the employee is discharged in bad faith . . . the covenant will not be enforced through the operation of equity."[122] The *Gomez* court reasoned that a fact-intensive inquiry into whether an employee is discharged with or without cause would be unduly burdensome and would detract from the central issues of a non-compete dispute.[123] Furthermore, the *Gomez* court emphasized the freedom of parties to contract with one another and placed the burden on the employee to decline employment if the covenant is not limited in the desired manner.[124]

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114. *Id.*
115. Central Adjustment Bureau, Inc. v. Ingram, 678 S.W.2d 28 (Tenn. 1984).
116. *Id.* at 35.
117. Empiregas, Inc. v. Bain, 599 So. 2d 971 (Miss. 1992).
118. *Id.* at 975.
119. *Granger v. Craven*, 199 N.W. 10, 14 (Minn. 1924).
120. Edin v. Jostens, Inc., 343 N.W.2d 691, 694 (Minn. Ct. App. 1984).
121. Gomez v. Chua Med. Corp., 510 N.E.2d 191 (Ind. Ct. App. 1987).
122. *Id.* at 194.
123. *Id.* at 195.
124. *Id.*

Two older cases from Massachusetts and Texas employed similar tests in refusing to enforce non-competition clauses against employees who were discharged without cause. In both *Economy Grocery Stores Corp. v. McMenamy*[125] and *Security Services, Inc. v. Priest*,[126] the courts noted that principles of equity might deny enforcement of a restrictive covenant if the employer acts arbitrarily and unreasonably in discharging the employee.[127] In *Priest*, the employer hired a salesperson, obtained the benefit of his client contacts and, after those contacts were "saturated," discharged the salesperson within a matter of months.[128] The employer's opportunistic conduct clearly amounted to an unreasonable exercise of its discretion to discharge the employee while simultaneously seeking to enforce a non-compete clause. In *McMenamy*, the facts indicated that the defendant, a manager at a department store, performed his job according to expectations only to be terminated "in circumstances involving some humiliation to him."[129] In a rather significant decision, the Supreme Court of Massachusetts took into account not only the employer's conduct, but also the employee's expectation of continuing his employment and the fact that the employer terminated the employment relationship in the midst of the Great Depression.[130] A countervailing public interest may have had some role in the court's decision.

c. The Balancing the Equities Analysis

The *McMenamy* ruling suggests that factors other than just the employer's conduct should be considered before enforcing a covenant not to compete against a discharged employee.[131] Several cases take the lead from this Depression-era decision and employ a more flexible balancing the equities analysis. South Dakota, Iowa and Missouri provide examples.

South Dakota courts take a unique and flexible approach in their analysis of covenants not to compete by making a clear distinction

125. Economy Grocery Stores Corp. v. McMenamy, 195 N.E. 747 (Mass. 1935).

126. Security Servs., Inc. v. Priest, 507 S.W.2d 592 (Tex. Civ. App. 1974).

127. *McMenamy*, 195 N.E. at 748; *Priest*, 507 S.W.2d at 595.

128. *Priest*, 507 S.W.2d at 594.

129. *McMenamy*, 195 N.E. at 748; *see also* Kroeger v. Stop & Shop Cos., Inc., 432 N.E.2d 566, 572 (Mass. App. Ct. 1982) (citing *McMenamy* and holding that if discharge is "inequitable," restrictive covenant may not be enforceable); *cf.* Custard Ins. Adjusters, Inc. v. Nardi, No. CV980061967S, 2000 WL 562318, at *15-16 (Conn. Super. Ct. Apr. 20, 2000) (finding that employer did not discharge employee in bad faith and declining to void non- compete on this ground; considering manner in which employee was terminated, whether he was replaced by younger worker, and personality clash with superiors).

130. *McMenamy*, 195 N.E. at 748-49.

131. *Id.*

between resignation and for cause terminations, on the one hand, and termination without cause cases on the other. If an employee voluntarily resigns, or is fired for cause, then a court will examine only whether the covenant is reasonable, both geographically and temporally, under the state statute governing restrictive covenants.[132] However, if an employee is fired through no fault of his own, then a court will scrutinize whether the agreement is reasonable, by giving consideration to: (1) the extent of the restraint, including its territorial scope and duration; (2) the nature of the business or profession involved, including the employee's position and duties; (3) the effect of enforcement on the discharged employee; and (4) the public interest in the employee being able to continue in that field.[133] The trial judge is obligated to consider these factors in a termination case and balance the competing interests to determine reasonableness.[134]

Iowa courts also employ a comprehensive balancing test. In *Ma & Pa, Inc. v. Kelly*,[135] the employer terminated a salesman of petroleum products during the 1982 recession, due to a change in market conditions and an unprofitable commission arrangement. The termination was clearly without cause.[136] The employer sued the employee after he went to work for a competitor, where he had undercut his former employer's bids, and obtained some of its largest customers.[137] The Supreme Court of Iowa reversed the trial court's grant of an injunction against the employee and declined to enforce the three-year, 25-mile non-compete clause.[138] The Court considered the following factors in its overall balancing test: (1) the discharge by the employer; (2) the hardship to the employee's family if the injunction were upheld; (3) the employee's limited skills in other fields; (4) his attempts to find other jobs without success; (5) the fact that his employment was terminated during a recession; (6) a well-known field of potential customers in the industry; and (7) the former employer's uncompetitive pricing.[139]

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132. *Id.* at 519; *see also* S.D. CODIFIED LAWS § 53-9-11 (Michie 2002) (containing maximum time and geographic limits on restrictive covenants).

133. Central Monitoring Serv., Inc., v. Zakinski, 553 N.W.2d 513, 519 (S.D. 1996).

134. *Id.*

135. Ma & Pa, Inc. v. Kelly, 342 N.W.2d 500 (Iowa 1984).

136. *Id.* at 501.

137. *Id.*

138. *Id.* at 503.

139. *Kelly,* 342 N.W.2d at 502-03.

Missouri courts relied on the well-reasoned opinion in *Kelly* to formulate a balancing the equities rule. In *Showe-Time Video Rentals, Inc. v. Douglas*,[140] the court announced that:

> [I]f a non-compete covenant is reasonable as to length of time and size of territory, and if the evidence establishes that the covenant is ancillary to a legitimate protectable interest of the party in whose favor the covenant runs, the covenant will be enforced by injunction *where the party against whom it runs is the party that terminates the arrangement* and begins competing against the other party.[141]

The court also held that injunctive enforcement would be granted in those instances where the party, in whose favor the covenant runs, terminates the arrangement with good cause.[142]

Nevertheless, the court did not establish a *per se* rule along the same lines as *Post* or *Bishop*. Instead, the *Douglas* court chose to rely on *Kelly*'s balancing the equities approach in its affirmation of the trial court's decision to deny injunctive relief.[143] The factors that the court deemed important in its balancing the equities analysis were: (1) the plaintiff's decision to terminate the agreement; (2) the availability of numerous distributors to supply movie rentals; (3) lack of any trade secrets; and (4) the unprofitability of the distribution arrangement to the supplier prior to termination.[144]

3. Cases Holding That Discharge Is Not a Factor to Consider

At the opposite end of the spectrum from pro-employee cases such as *Post, Brobston* and *Bishop* lie the cases that are decidedly protective of the employer's business interests. These rare cases hold that an involuntary discharge is not even a factor to consider when determining the enforceability of a non-competition clause.

a. *The Twenty-Four Collection, Inc. v. Keller*

In *The Twenty-Four Collection, Inc. v. Keller*,[145] the former employee (Keller), a buyer for a women's retail clothing store, was discharged by Twenty-Four Collection eighteen months after she signed a two-year non-compete that encompassed Dade, Broward and Palm

140. Showe-Time Video Rentals, Inc. v. Douglas, 727 S.W.2d 426 (Mo. Ct. App. 1987).

141. *Id.* at 433.

142. *Id.*

143. *Id.* at 433-34.

144. *Douglas*, 727 S.W.2d at 434; *see also* Property Tax Representatives, Inc. v. Chatam, 891 S.W.2d 153, 157-58 (Mo. Ct. App. 1995) (affirming trial court's denial of injunction on non-competition clause when employee was discharged without good cause; noting that trial court made finding of fact that reasons for dismissal were not "for cause" when employee conducted casual business on his own time that did not amount to conflict of interest with employer).

145. Twenty Four Collection, Inc. v. Keller, 389 So. 2d 1062 (Fla. Dist. Ct. App. 1980).

Beach Counties in Florida.[146] A month after she was fired, Keller went to work for 24 Collection's primary competitor, Cache, and 24 Collection brought a claim for an injunction to prevent Keller from working for Cache.[147] The Third District Court of Appeals reversed the trial court's order denying 24 Collection's injunction and remanded for a determination as to whether the temporal and geographic limitations of the non-compete clause were reasonable.[148] The court held that the trial judge erred in balancing the equities and avoiding a harsh result that would have emanated from the injunction.[149] The court alluded to, but never directly confronted, the involuntary discharge, and it instead relied on a strict reading of Florida law, which does not allow a court to consider whether the enforcement of a non-compete would lead to an "unjust result."[150] In Florida, as the *Keller* court's analysis suggests, as long as a covenant is reasonably limited in time and geographic scope, it is valid.[151] Since Keller signed the non-compete, she was bound to it, regardless of how her employment ended or whether other equitable factors in her favor were present.[152] Florida's approach is the opposite of that taken in South Dakota, which has a similar statute governing restrictive covenants but mandates that a trial judge balance the equities when an employee is fired without cause.[153] To date, Florida is the only jurisdiction unwilling to consider an employee's termination when judging whether a non-compete is enforceable.[154]

b. A Florida Limit to *Keller*?

The Florida rule in *Keller* was eroded somewhat by a subsequent appellate court ruling in *Kupscznk v. Blasters, Inc.*[155] In the *Kupscznk*

146. *Id.* at 1062.

147. *Id.*

148. *Id.* at 1064.

149. *Keller,* 389 So. 2d at 1063.

150. *Id.* (citing FLA. STAT. ANN. § 542.12(2) (West 1977) (current version at FLA. STAT. ANN. § 542.33(2) (West 2002))).

151. *Id.*

152. *Cf.* Gold Coast Media, Inc. v. Meltzer, 751 So. 2d 645, 646 (Fla. Dist. Ct. App. 1999) (holding that employee's promise not to compete upon "my termination from employment or engagement by the company" constituted promise not to compete in cases of both voluntary and involuntary termination).

153. Central Monitoring Serv., Inc. v. Zakinski, 553 N.W.2d 521 (S.D. 1996).

154. *Cf.* Weber v. Tillman, 913 P.2d 84, 91-92 (Kan. 1996) (applying balancing test to determine reasonableness of non-compete's enforceability, but failing to analyze physician's involuntary discharge); General Surgery, P.A. v. Suppes, 953 P.2d 1055, 1057 (Kan. Ct. App. 1998) (declining to enforce covenant not to compete in termination case when contract language indicated that *employee* must end employment before covenant could be triggered).

155. Kupscznk v. Blasters, Inc., 647 So. 2d 888 (Fla. Dist. Ct. App. 1994).

case, the court addressed a claim by an employee that his former employer's reduction of his commissions constituted a breach of his employment contract, rendering the non-compete unenforceable. On the merits, the court ruled in favor of the employer.[156] However, in *dicta*, the court stated:

> We recognize, however, that in rare circumstances equitable considerations could possibly render a noncompetition agreement void. For instance, had Blasters hired Kupscznk under the same terms and then terminated him without cause after a very short time, even though the termination would not be wrongful under the Florida at-will employment doctrine, Blasters' conduct might be deemed unconscionable and a court of equity would not permit its perpetuation by entry of an injunction.[157]

While this statement arguably is at odds with *Keller*, it appears that, to reconcile the two cases, the employee still would bear a heavy burden of proving unconscionability as an affirmative defense. In other words, the issue would not be examined in the context of overall reasonableness, which Section 542.12(2) of the Florida statutes does not permit.[158] However, *Kupscznk* gives employees some ability to argue that the enforcement of a non-compete might be manifestly unjust in the case of an involuntary termination.

Section 542.12(2), which has been interpreted to remove any discretion the trial judge may have to balance the equities, has not received universal acclaim. In *Capraro v. Lanier Business Products, Inc.*,[159] Justice Overton, in a dissenting opinion, took the unusual step of calling on the Florida legislature to modify or repeal Section 542.12(2), to allow courts to use "proper equitable principles when injunctive relief is sought to enforce noncompetition agreements."[160]

4. Analysis

a. The Fault Inherent in the 'Cause/Without Cause' Distinction

Rao, as well as other decisions employing the bad faith analysis, may have recognized a problem with crafting a *per se* rule that makes a distinction between terminations without cause and those with cause. Quite simply, it is extremely difficult to determine what constitutes cause for dismissal. Frequently, an employment contract will list several categories of conduct that qualify as cause for dismissal, such

156. *Id.* at 891.

157. *Id.*

158. FLA. STAT. ANN. § 542.12(2) (West 1977) (current version at FLA. STAT. ANN. § 542.33(2) (West 2002)).

159. Capraro v. Lanier Bus. Prods., Inc., 466 So. 2d 212 (Fla. 1985).

160. *Id.* at 214 (Overton, J., dissenting).

as conviction of a felony, fraud, or insubordination. However, in the absence of such a contractual provision, when does conduct cross the line so as to warrant dismissal for cause? Even if a contract defines what cause is, should courts be constrained by that definition, which may be part of an adhesion contract, or should they adopt a more judicially accepted definition of cause? Logically, the specific contract language should be a consideration, but certainly not a controlling one, since courts have historically modified the precise contract language in restrictive covenant disputes to comport with an overarching standard or reasonableness.

Some states define "cause" under the common law, which might give a court some guidance in applying a *per se* rule. In Illinois, for instance, "cause" has been defined as "some substantial shortcoming, recognized by law and public opinion as a good reason for termination."[161] New Mexico's definition is marginally more helpful. In *Danzer v. Professional Insurors, Inc.*,[162] the court held that termination for cause guarantees against the "whim and caprice of an employer" and allows discharge only for legal cause, that is, "some causes inherent in and related to qualifications of the employee or a failure to properly perform some essential aspect of the employee's job function."[163] Good cause would be easy to establish in cases where an employee committed fraud, breached his fiduciary duty, or violated company policy.[164] At the opposite end of the spectrum, economically motivated terminations, discharges resulting from a reduction-in-force and terminations due to a personality clash, almost certainly cannot be considered as dismissals for good cause.[165]

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161. Norman v. Bd. of Fire & Police Comm'rs of Zion, 614 N.E.2d 499, 504 (Ill. App. Ct. 1993).

162. Danzer v. Prof'l Insurors, Inc., 679 P.2d 1276 (N.M. 1984).

163. *Id.* at 1280-81.

164. *See* Superior Gearbox Co. v. Edwards, 869 S.W.2d 239, 244 (Mo. Ct. App. 1993) (discussing the fact that "just cause" is not a well-defined concept under Missouri law, but that it has been held to encompass an employee's "lying, stealing, repeated absences or lateness, destruction of company property, brawling and similar infractions."); Kroeger v. Stop & Shop Cos., Inc., 432 N.E.2d 566, 572 (Mass. App. Ct. 1982) (employee theft would constitute termination for "cause").

165. Brooks v. Bd. of Comm'rs of CHA, No. 97 C 5166, 1998 WL 214669 at *3 (N.D. Ill. Apr. 21, 1998) (reduction-in-force is fundamentally different than a termination for cause); Franks v. Magnolia Hosp., 888 F. Supp. 1310, 1313-14 (N.D. Miss. 1995) (same); Insulation Corp. of Am. v. Brobston, 667 A.2d 729, 735 n.6 (Pa. Super. Ct. 1995) (noting that economically motivated discharge would void non-compete). *But cf.* Custard Ins. Adjusters, Inc. v. Nardi, No.CV980061967S, 2000 WL 562318 at *15-16 (Conn. Super. Ct. Apr. 20, 2000) (noting employee's personality clash with former employer, but declining to release employee from non-compete).

The toughest cases to clarify in the for cause/without cause spectrum are those where an employer claims that the employee's performance was inadequate. *Rao* suggests that inadequate performance does rise to the level of termination for cause and that an employee's dismissal on this basis may not relieve him of an otherwise valid non-compete obligation.[166] Conversely, *Brobston*, and even the dissenting opinion in that case, implies that a performance-based termination, short of insubordination or breach of a fiduciary duty, does not rise to the level of cause.[167]

In the final analysis, the mere labeling of a discharge as for cause or without cause cannot control. Without question, it is a factor for the court to examine, but crafting a rule on this basis seems unworkable and would lead to an inquisition into the discharged employee's job performance and whether it rises to the level of good cause for dismissal. A collateral inquiry into past job performance is not the most efficient way of resolving disputes involving restrictive covenants, because the vast majority of such cases need to be dealt with on emergency injunction hearings.[168] Since the parties only have the benefit of limited, expedited discovery, the hearings must focus on the interests of the employer, the employee and the public in determining whether the covenant should be enforced.

b. Florida's Anomaly

Florida's approach, as stated in Justice Overton's dissenting opinion in *Capraro*, seems unduly restrictive of competition, could yield potentially inequitable results, and provides no judicial check on abusive practices by employers who extract non-competes from their employees. Rather, Florida's test should be considered an anomaly, the product of a statute that removes all of the trial judge's discretion to consider notions of equity in deciding whether to enforce a covenant not to compete. By its very nature, the test is antithetical to any injunction proceeding.

c. The Flaw of the Conduct-Driven 'Bad Faith' Rule

Although both *per se* rules are too inflexible, the bad faith analysis is far from perfect. The most troubling aspect of the bad faith test is the courts' single-handed focus on the employer's conduct in effectuating the termination, without regard for its impact on the employee

166. Rao v. Rao, 718 F.2d 219, 224 (7th Cir. 1983).

167. *Brobston*, 667 A.2d at 735, 739 (Del Sole, J., dissenting).

168. *See* Gomez v. Chua Med. Corp., 510 N.E.2d 191, 195 (noting how inquiry into reason for termination does not fit with role courts should play in enforcing non-compete clauses).

or the public interest. *Rao* presents a rather classic situation in which the employer had a bad motive for terminating the employee – preventing the employee from obtaining an equitable interest in the business that the employee had indisputably earned.[169] However, it is fair to say that an employer's ill motive or bad faith does not control many terminations.

In the more straightforward termination, are other elements, such as the effect of the termination on the worker or the presence of an overriding public interest, to be considered? The answer is not particularly clear in bad faith jurisdictions, but case law suggests that the courts are willing to step outside the restraints of the bad faith analysis and consider other factors, even if they do not acknowledge that such factors are part of a governing test. The 1935 *McMenamy* decision, which purports to apply a derivative of the bad faith approach, suggests that courts should examine factors other than the employer's conduct or underlying motive.[170]

d. The Soundness of the 'Balancing the Equities' Approach

The balancing the equities approach is a logical extension of what considerations the *McMenamy* court took into account. The balancing the equities test solves the fundamental flaw of the *Rao* analysis; all equitable factors, not just an employer's conduct, warrant scrutiny in determining the enforceability of a restrictive covenant in a termination case. The decisions in *Kelly* and *Douglas* provide examples of how courts have used a flexible balancing test to achieve a just result. The balancing the equities approach allows a trial judge to analyze a host of factors, some of which are likely to be unique to individual cases. In terms of the employer's interests, the most likely factors that a court will consider are: (1) the strength of the protectable interest;[171] (2) the reason for the termination;[172] (3) the nature of the business;[173] (4) the protections through a less restrictive non-solicitation or non-disclosure covenant;[174] and (5) whether the discharge was conducted in bad faith.[175]

With respect to the employee's interests, the hardship resulting from enforcement is a primary consideration. Courts will presumably

169. *Rao*, 718 F.2d 219 at 221.
170. Economy Grocery Stores Corp. v. McMenamy, 195 N.E. 747, 748-49 (Mass. 1935).
171. Showe-Time Video Rentals, Inc. v. Douglas, 727 S.W.2d 426, 434 (Mo. Ct. App. 1987).
172. *Brobston*, 667 A.2d at 734-35.
173. *Douglas*, 727 S.W.2d at 434.
174. *Brobston*, 667 A.2d at 735.
175. Rao v. Rao, 718 F.2d 219, 223 (7th Cir. 1983).

take into account the employee's skills, tenure with the employer, education level, and experience in other fields of work.[176] Other secondary factors, if applicable, may also need to be considered, such as the employee's opportunities, if any, to negotiate the terms of the employment contract[177] and any other available job opportunities.[178]

Lastly, certain public interests need to be considered. Two primary public interests that should influence a trial judge's decision are the economic climate that is prevailing at the time of discharge[179] and whether the community would be deprived of the employee's unique services, such as whether a comparable professional can replace the employee.[180]

The main advantages of the balancing the equities approach are its flexibility and the fact that it gives the trial judge discretion to consider factors unique to each case. Given the myriad situations in which non-compete disputes arise, the balancing the equities test permits courts to adapt their analysis to account for all relevant factors, which the *per se* rules and the bad faith test do not.[181]

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176. Ma & Pa, Inc. v. Kelly, 342 N.W.2d 500, 502-03 (Iowa 1984); *see also* Philip G. Johnson & Co. v. Salmen, 317 N.W.2d 900, 904 (Neb. 1982) (noting that considerations in evaluating reasonableness include, *inter alia*, "the covenantor's training, health, education and needs of his family.").

177. *See* Weseley Software Dev. v. Burdette, 977 F. Supp. 137, 141 (D. Conn. 1997) (noting employee's opportunity to suggest changes to employment contract); *Salmen*, 317 N.W.2d at 904 (considering "degree of inequality of bargaining power").

178. *Kelly*, 342 N.W.2d at 502-03.

179. *See id.* (noting that employee was discharged during the 1982 recession); *Salmen*, 317 N.W.2d at 904; *McMenamy*, 195 N.E. at 748-49.

180. *See* Iredell Digestive Disease Clinic, P.A. v. Petrozza, 373 S.E.2d 449, 455 (N.C. Ct. App. 1988) (declining to enforce covenant not to compete on basis of public interest in receiving choices in adequate, affordable health care), *aff'd*, 377 S.E.2d 750 (N.C. 1989).

181. The author respectfully disagrees with the conclusion set forth in an article addressing the same subject, which advocates a uniform approach in analyzing non-competition covenants, regardless of how the relationship ended. *See* Andrew J. Gallo, Comment, *A Uniform Rule for Enforcement of Non-Competition Contracts in Relation to Termination Cases*, 1 U. PA. J. LAB. & EMP. L. 719 (Fall 1998). Specifically, this article advocates that the Florida rule is the most sound, and it reasons "the method of termination" has "no direct bearing upon the separate exchange that is the subject of the non-competition clause." *Id.* at 741-42. As a practical matter, it is only in the rarest of cases that an employee – either prospective or existing - has enough leverage to negotiate, modify or remove a restrictive covenant from an employment contract presented to her. Therefore, it is highly unusual for employer and employee to have a "separate exchange" for a restrictive covenant. If the employer and employee do bargain separately for the covenant, then this may be a factor for a court to consider. However, to remove such a key element from a reasonableness analysis ignores not only the historical function of chancery courts to consider all equitable considerations before fashioning injunctive relief, but also the unique facts and circumstances inherent in restrictive covenant disputes.

B. *Non-Solicitation Clauses*

Customer non-solicitation clauses are far less restrictive of competition than traditional non-competes. They represent the classic form of an activity restraint and, in theory, should be narrowly tailored to protect client relationships. Nevertheless, the presence of a non-solicit clause in a former employee's contract is a significant deterrent for that worker in his efforts to find a new job. For many salespersons, the extent of their contacts and ability to bring in a book of business to their new job is of paramount importance, not only for getting hired, but also for attaining an incentive compensation level commensurate with their experience. Given these business realities, how should non-solicitation clauses be judged in involuntary discharge cases?

Only two states have addressed the question of whether a customer non-solicitation clause is affected by an employee's involuntary discharge. Adding to the lack of clarity emanating from non-competition cases, the decisions reach opposite results. Missouri courts have determined that otherwise enforceable non-solicit clauses remain valid in a termination case, while New York courts hold that they do not.

1. The *Chatam* Rule - Covenant Enforceable

In *Property Tax Representatives, Inc. v. Chatam*,[182] the Missouri Court of Appeals addressed whether a non-competition clause and a non-solicitation clause are enforceable against an employee who is terminated without cause.[183] The trial court in *Chatham*, following the rule established in *Douglas*, held that both restrictive covenants were unenforceable.[184] On appeal, the court reversed the trial court's decision and upheld the non-solicitation covenant.[185] In noting that the "non-solicitation provision of the contract stands on different footing than the non-competition provision," the court held that it was "perfectly fair" to prevent the employee from exploiting, for his own benefit and the employer's detriment, the customer contacts, goodwill, and his knowledge of the clients' business.[186] The *Chatam* decision clearly separates non-competition clauses from other activity-based restrictive covenants.

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182. Property Tax Representatives, Inc. v. Chatam, 891 S.W.2d 153 (Mo. Ct. App. 1995).

183. *Id.* at 155.

184. *Id.* at 157-58.

185. *Id.* at 158.

186. *Chatham,* 891 S.W2d at 158; *see also* American Pamcor, Inc. v. Klote, 438 S.W.2d 287, 291 (Mo. Ct. App. 1969) (enforcing customer non-solicitation covenant after employee was discharged in "reduction-in-force").

2. The *UFG International* Rule - Covenant Unenforceable

In stark contrast to *Chatam* is the New York Bankruptcy Court's decision in *In re UFG International, Inc.*[187] In *UFG*, a Chapter 11 trustee brought an adversary proceeding against former employees, claiming violations of customer non-solicitation provisions in their employment contracts.[188] Relying on the *Post* decision, the court stated:

> These cases (*Post* and the cases following it) involved even greater restrictions on employee mobility than do the covenants that the plaintiff seeks to enforce in this case. In each of the foregoing cases, the covenant at issue would have prevented the employee from engaging for a period of time in any work of the type that had been done for the employer, while in this case the covenants merely forbade the solicitation of UFG's customers for a period of time. *Nonetheless, the same rule should apply.* The cases, which hold that a covenant not to compete is unenforceable against an employee who is terminated without cause, are premised on the unfairness of permitting an employer who has destroyed the mutuality of obligation on which the covenant rests to benefit from the covenant. [Citing *Post*]. *The same reasoning applies even when the covenant does not entirely restrict the employee's mobility, but restricts him only from dealing with certain customers.* Regardless of the scope of the restrictive covenant, an employer cannot hobble his employee by terminating him without cause and then enforcing a restriction that diminishes his ability to find comparable employment.[189]

New York, by virtue of *Post* and *UFG*, is the most pro-employee state in terms of invalidating restrictive covenants in discharge cases. The court in *UFG* recognized that a customer non-solicitation covenant can be tantamount to a non-compete and can effectively shut a worker out of prospective job opportunities.[190] The *UFG* court appeared to focus not on the precise type of restrictive covenant at issue, but rather: (1) the restriction on employee mobility; (2) the employer's unilateral decision to discharge the employee without cause; and (3) the inherent unfairness of first firing someone and then attempting to enforce a restrictive covenant.[191]

C. *Non-Disclosure Clauses*

Covenants restricting the disclosure of trade secrets and confidential information should be enforced, regardless of how the employ-

187. *In re* UFG Int'l, Inc., 225 B.R. 51 (S.D.N.Y. 1998).
188. *Id.* at 52-53.
189. *Id.* at 56 (emphasis added).
190. *Id.*
191. *UFG*, 225 B.R. at 56.

ment relationship ends. The court in *Brobston*, one of the strongest pro-employee decisions, upheld a non-disclosure covenant in the context of an involuntary discharge without cause.[192] Since employees have a common law duty not to disclose confidential information of a former employer,[193] and can be sued under a trade secret misappropriation theory, the enforceability of non-disclosure covenants almost certainly will not depend on the method or manner of termination.

D. *Other Issues in the Termination Context*

Although the vast majority of employment relationships end either in resignation by the employee or termination by the employer, certain changes in an employee's status do not necessarily fit into either of those categories. For example, an employee may have a term contract for a number of years and, at the end of the contract period, the parties simply decline to renew it. Is the employee bound by a restrictive covenant contained in the expired agreement? Additionally, an employee may claim that she was constructively discharged, in that she felt that the working conditions were so intolerable that anyone would feel forced to resign. How should a constructive discharge be analyzed if an employee seeks to compete with her former employer? Finally, an employer may sell the business to a corporate purchaser, one for whom the employee had no expectation of rendering services. In the context of a small, closely-held business, the change of control can have significant repercussions within the employee ranks. Is the restrictive covenant assignable? For all of these potential fact-patterns, courts have come up with some unique, and divergent, analyses.

1. Expiration of Contract Term/Nonrenewal

Although most employees have at-will status, so that the employment relationship can be terminated at any time, with or without cause, certain employees have term contracts. These agreements set the number of years that the parties are obligated to continue the employment relationship. Frequently, these contracts contain 'rollover' clauses, which provide for automatic renewal of the agreement from

192. Insulation Corp. of Am. v. Brobston, 667 A.2d 729, 737-38 (Pa. Super. Ct. 1994).

193. Anderson Chem. Co. v. Green, 66 S.W.3d 434, 442 (Tex. Ct. App. 2001) (stating that while a former employee may use general skills, knowledge and experiences acquired during employment, a former employee may not use trade secrets or other confidential information acquired during employment); Ed Nowogroski Ins., Inc. v. Rucker, 971 P.2d 936, 941-42 (Wash. 1999) (discussing how even without an enforceable non-compete covenant, a former employee still remains under a duty not to use or disclose, to the harm of his former employer, trade secrets acquired during employment).

year-to-year, unless one party provides notice of its intent not to renew in advance of the contract's expiration date.

Reported case law has given relatively little attention to whether a covenant not to compete is enforceable if the employee's term contract simply lapses or expires. In such a situation, neither party affirmatively terminates the agreement; rather, when the term comes to an end, the parties walk away from the relationship. Is the restrictive covenant enforceable, or is the employee free to work in whatever capacity she chooses? An employer could argue that it bargained for the covenant, regardless of how the employment relationship ended, and that it should be enforced even if no premature termination occurs. On the other hand, the employee could argue that the covenant applies only to an early parting of the ways, whether at the behest of the employee or employer, and does not apply when the contract term expires. As can be gleaned from the case law, the results of covenant disputes in nonrenewal cases turn on the issue of contract construction.

a. Expansive Reading of Contract - *The Daniel Boone Clinic*

In *The Daniel Boone Clinic, P.S.C. v. Dahhan*,[194] a medical clinic hired Dahhan for a term of eighteen months and provided for a covenant not to compete for a commensurate period "following the termination of employment."[195] At the end of the contract term, the clinic declined to renew Dahhan's contract, and he immediately opened an office for the private practice of medicine within the covenant's restricted territory.[196] The clinic filed a claim for injunctive relief against Dahhan to enforce the 18-month covenant not to compete in his expired employment contract.[197] The court rejected Dahhan's argument that, since his contract was not "terminated" by the clinic, the plain meaning of the contract did not preclude him from competing.[198] The court reasoned that, "termination means *ending*, however accomplished," and that an affirmative act of either party or its expiration could end a contract.[199]

194. The Daniel Boone Clinic, P.S.C. v. Dahhan, 734 S.W.2d 488 (Ky. Ct. App. 1987).

195. *Id.* at 489.

196. *Id.* at 490.

197. *Id.*

198. *The Daniel Boone Clinic*, 734 S.W.2d at 490.

199. *Id.*

b. Narrow Reading of Contract - *Clinch Valley Physicians*

The Supreme Court of Virginia reached virtually the opposite result in *Clinch Valley Physicians, Inc. v. Garcia.*[200] In the *Clinch Valley* case, Garcia signed an employment agreement with his physician shareholder group for a term of one year, which was to continue from year-to-year unless either party gave its intent not to renew within thirty days of expiration.[201] The contract also contained a covenant not to compete, which stated that, "Upon termination of this agreement, for any reasons whatsoever, [Garcia] shall not, for a period of three (3) years thereafter, engage in the practice of medicine or surgery in a radius of twenty-five (25) miles of Richlands."[202] The physician group notified Garcia that it would not renew his employment contract.[203] Garcia filed a declaratory judgment action seeking to determine the enforceability of the contract's non-competition clause.[204] The Court noted that the non-compete was intended to go into effect upon termination of the agreement "*for any reasons whatsoever.*"[205] However, the court held that the non-compete did not become effective upon the parties' failure to renew the contract.[206] Instead, the Court examined other provisions of the employment agreement and found that the physician group could not terminate Garcia for reasons other than cause, prior to the expiration of the contract.[207] Construing the language of these provisions with the termination language in the non-compete provision, the *Clinch Valley* court found that application of the restrictive covenant was limited to terminations for cause, even if this is not what the physician group had intended.[208]

The Daniel Boone Clinic and *Clinch Valley* are difficult to reconcile, and the decisions provide an example of what can happen when courts fail to articulate an overriding principle and instead rely on principles of contract construction. Arguably, Garcia's agreement was much clearer, since the covenant not to compete was to be enforced on "termination . . . for any reasons whatsoever." However, the *Clinch Valley* court held that the language was not applicable in the context of con-

200. Clinch Valley Physicians, Inc. v. Garcia, 414 S.E.2d 599 (Va. 1992).

201. *Id.* at 600.

202. *Id.*

203. *Id.*

204. *Clinch Valley*, 414 S.E.2d at 601.

205. *Id.*

206. *Id.* (stating that the Court is limited to the language of the contract and that CVP should have said stated its intentions in explicit terms if it had desired to make the restrictive covenant applicable upon renewal).

207. *Id.*

208. *Clinch Valley*, 414 S.E.2d at 601.

tract non-renewals, ultimately ruling in favor of the employee.[209] In *The Daniel Boone Clinic*, despite the fact that the agreement only mentioned "termination," the court broadly interpreted the contract and held that the restrictive covenant was operative even upon expiration of the contract term.[210] The results are tough to square.

c. Florida's Rule - "Expiration" Must Be Clearly Included

Florida, which is often regarded as the most pro-employer state in terms of restrictive covenant enforcement, takes a more employee friendly approach in its nonrenewal cases; 'expiration' must be mentioned in the contract as a non-compete trigger. In *Brenner v. Barco Chem. Div., Inc.*,[211] the Florida District Court of Appeals held that a non-compete provision survived the expiration of an employment agreement, where it *expressly* provided that its terms would continue after expiration if the employee continued to work without renewing the contract, and where the non-compete clause would continue following "expiration or termination" of the employment.[212] Florida courts held in both *Sanz v. R.T. Aerospace Corp.*[213] and *Storz Broadcasting Co. v. Courtney*,[214] that a non-compete was unenforceable in a written, fully performed and expired employment agreement, since the covenants were *only* applicable if the employee terminated employment during the life of the contract.[215] Florida clearly does not prohibit the enforcement of non-competes following the expiration of a term contract as a *per se* rule, but the issue is one of contract drafting and whether the covenant not to compete clearly takes effect upon expiration of the contract.[216]

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209. *Id.*

210. The Daniel Boone Clinic, P.S.C. v. Dahhan, 734 S.W.2d 488, 490 (Ky. Ct. App. 1987); *see also* Robert S. Weiss & Assocs., Inc. v. Wiederlight, 546 A.2d 216, 222 (Conn. 1988) (upholding enforcement of non-compete after lapse of four-year employment term contract which was not renewed by employer, on grounds that "terminated" includes "lapse or expiration"); *cf.* Volunteer Firemen's Ins. Servs., Inc. v. CIGNA Prop. & Cas. Ins. Agency, 693 A.2d 1330, 1339-40 (Pa. Super. Ct. 1997) (upholding restrictive covenants in agreement between distributor of insurance services and underwriter when distributor gave intent not to renew "rollover" term contract; finding that "termination" included "expiration" of contract term); Carvel Corp. v. Eisenberg, 692 F. Supp. 182, 184-85 (S.D.N.Y. 1988) (upholding non-compete clause in licensing agreement on same grounds).

211. Brenner v. Barco Chem. Div., Inc., 209 So. 2d 277, 278 (Fla. Dist. Ct. App. 1968).

212. *Id.*

213. Sanz v. R.T. Aerospace Corp., 650 So. 2d 1057 (Fla. Dist. Ct. App. 1995).

214. Storz Broad. Co. v. Courtney, 178 So. 2d 40 (Fla. Dist. Ct. App. 1965), *cert. denied*, 188 So. 2d 315 (Fla. 1966).

215. *Sanz*, 650 So. 2d at 1059; *Courtney*, 178 So. 2d at 42.

216. *See also* Karlin v. Weinberg, 390 A.2d 1161, 1165 n.2 (N.J. 1978) (agreeing with state appellate court that post-employment restrictive covenant was not terminated by expiration of contract).

d. Analysis

The enforceability of non-competition clauses in expired term contracts has become one of judicial contract construction. If courts continue to analyze cases in this manner, Florida's approach, which requires 'expiration' to be articulated conspicuously in the contract, is the most logical because it provides the employee with notice of what events will trigger the covenant. From a reasonableness standpoint, it makes far greater sense for courts to analyze which party declined to renew the term contract. Logically, the employee wanted to keep working, but the employer chose not to renew the agreement, this should be equated to termination without cause and regarded as a factor strongly favoring the employee in a balancing the equities inquiry. Such an analysis would have changed the outcome in *The Daniel Boone Clinic*, since the employer elected not to renew the rollover term contract. On the other hand, if the employee gave the employer notice of his intent not to renew the term contract, this would be more akin to a voluntary resignation, particularly if the employee had, in the past, renewed the contract as a matter of course.

A second, but more tenuous, argument that the employee may have concerns the ancillarity doctrine. If an employment contract lapses or expires, then a covenant not to compete purporting to take effect upon expiration of the agreement could be considered as not ancillary to a valid transaction. Put another way, a court may consider that a covenant amounts to a "naked" covenant, or an outright restraint of trade, which is *per se* invalid.[217] If both parties to a term contract bargain for a definite end of the employment relationship, then a non-compete that takes effect after a predetermined end to the contract is not ancillary to a valid relationship or transaction. Conversely, in the at-will setting, neither party bargains for a definite end to the employment relationship, and the restrictive covenant is intended to protect the employer from a premature, *not predestined*, end to the relationship. Apparently, no court has addressed the ancillarity doctrine in this context.

2. Constructive Discharge

A claim of constructive discharge normally arises out of an employment discrimination or harassment case. In such cases, the employee charges that her former employer behaved in a manner that made the work environment so intolerable or unbearable that she had no choice

217. Central Water Works Supply, Inc. v. Fisher, 608 N.E.2d 618, 625 (Ill. App. Ct. 1993) (Cook, J., specially concurring).

but to quit – that in effect, she was discharged.[218] Quite simply, if an employee proves that she was constructively terminated, the separation is a 'hybrid' termination-resignation and most likely a termination without cause. In certain states, such as New York and Illinois, the classification of a termination as one without cause can be outcome-determinative and effectively void a non-compete.

a. The Curious *Alliance Metals* Decision

Due to the fact that most terminations are easily classified as resignations or terminations, this issue has not appeared with great frequency in reported decisions concerning restrictive covenants. However, the issue of constructive discharge was prevalent in *Alliance Metals, Inc. of Atlanta v. Hinely Indus., Inc.*[219] In the *Alliance Metals* case, Hinely had a five-year employment contract, which included a two-year non-compete provision, to serve as President of a wholly-owned subsidiary of Alliance Metals.[220] Hinely became disenchanted with his employment almost immediately.[221] During the first year of his employment, Hinely did not receive any incentive compensation, due to the company's alleged poor financial performance, and he suspected that his superiors at the parent company had manipulated the books to deny him such compensation.[222] Hinely also suspected that the chairman of the parent company was engaged in a price-fixing scheme with a competitor.[223] Hinely began cooperating with the Department of Justice and, shortly thereafter, was stripped of his day-to-day duties at the company.[224] Ten days after Hinely was effectively put on paid leave, the chairman of the parent company admitted to violating the Sherman Act, thereby confirming Hinely's suspicions.[225] Hinely then formally resigned from Alliance Metals, stating that the company's actions had, in effect, amounted to a "constructive discharge" of his term contract.[226] Hinely immediately incorporated his own competing entity, and Alliance Metals sued him for, *inter alia*, breach of the employment contract.[227]

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218. *See* Rosado v. Santiago, 562 F.2d 114, 119 (1st Cir. 1977) (setting forth constructive discharge standard); Green v. Indus. Specialty Contractors, Inc., 1 S.W.3d 126, 134 (Tex. Ct. App. 1999) (same).

219. Alliance Metals, Inc. of Atlanta v. Hinely Indus., Inc., 222 F.3d 895 (11th Cir. 2000).

220. *Id.* at 897.

221. *Id.* at 898.

222. *Id.*

223. *Alliance Metals*, 222 F.3d at 898.

224. *Id.*

225. *Id.*

226. *Id.*

227. *Alliance Metals*, 222 F.3d at 899.

Hinely defended the lawsuit on the grounds that he was constructively discharged, and that the non-compete was void, by its own terms, because Alliance had effectively terminated him without cause.[228] The court examined the language in Hinely's contract, which provided that the restrictive covenant:

> [S]hall be null and void in the event *Employee is terminated by Employer without cause* or if the Employer materially breaches the terms of this agreement and fails to cure any such material breach within thirty (30) days after notice from the Employee specifying the breach and requiring it to be cured.[229]

The contract also provided for the application of Pennsylvania law, which, given the holding in *Brobston*, would seemingly permit Hinely to void the non-compete if he could prove his constructive discharge claim at trial. However, the court held that Hinely's allegations of constructive discharge would not, even if proven, constitute a termination by the Employer without cause, so as to render the non-compete null and void.[230]

The *Alliance Metals* court's reasoning strains credulity in light of the fact that Pennsylvania law applied to Hinely's restrictive covenant. First, the court simply could have held that Hinely failed to comply with the 'notice and opportunity to cure breach' provision of the contract and declined to address the constructive discharge issue.[231] Second, the court could have affirmed the district court's decision on the grounds that Hinely failed to meet the rigorous standard of proving constructive discharge, which required him to produce enough evidence "from which a reasonable finder of fact could conclude that his working conditions were so intolerable that a reasonable person in his position would be compelled to resign."[232] Instead, the court chose to examine the question of whether a constructive discharge constituted a termination without cause. The court placed significant value on the words "by employer" in the non-compete provision.[233] According to the Eleventh Circuit, this language "contemplate[d] a conscious choice by Alliance Atlanta to terminate Hinely without cause in order to free him of his contractual duty not to compete."[234] The key words "by employer" before "without cause" foreclosed an "unintentional invalidation of the non-competition provision that could result from a

228. *Id.* at 899-900.
229. *Id.* at 902 (emphasis added).
230. *Id.* at 903.
231. *Alliance Metals*, 222 F.3d at 903.
232. Highhouse v. Avery Transp., 660 A.2d 1374, 1376 (Pa. Super. Ct. 1995).
233. *Alliance Metals*, 222 F.3d at 902.
234. *Id.*

constructive discharge."[235] Accordingly, Hinely could not equate constructive discharge with termination "by [the] employer" without cause.[236]

In light of *Brobston*, which raises a strong presumption against the enforceability of a non-compete in a termination case,[237] the *Alliance Metals* case produced a strange outcome, to say the least. For example, the court never even cited *Brobston* or analogized a constructive discharge to a termination without cause. Although the parameters of the *Brobston* holding are not well-defined, that case does state clearly that it should make no difference whether there is specific contractual language allowing an employer to enforce a restrictive covenant in a discharge case.[238] In fact, the employment contract at issue in the *Brobston* case, similar to most employment contracts, provides that the non-compete is enforceable "[o]n the termination of Employee's employment *for whatever reason . . .*"[239] According to the *Alliance Metals* court, the relevant inquiry is not the reasonableness of enforcing a restrictive covenant against a discharged worker; rather the sole inquiry is the contract's language and whether it allows for enforcement in such as case.[240] If the court explored the enforceability of the covenant under *Brobston*, and if Hinely were able to prove that he was constructively discharged, Hinely most likely could have voided the non-compete. It is difficult, if not impossible, to reconcile *Alliance Metals* with *Brobston*; perhaps the Eleventh Circuit thought it was applying Florida law.

b. The Narrow Contract Reading in *Key Temporary Personnel*

The Oklahoma appellate court reached a similar result in *Key Temporary Personnel, Inc. v. Cox*.[241] In the *Cox* case, the court held that an employee's claim of "constructive discharge" was not a defense to the enforceability of a customer non-solicitation clause.[242] The court chose to rely on a strict contract construction approach, rather than analyzing the case under an overall requirement of reasonableness. In *Cox*, the employee's non-solicitation clause took effect if her employment ceased for any reason, without regard for the nature of her termination or even whether a breach of the agreement caused the end

235. *Id.*
236. *Id.* at 903.
237. *See supra*, Section III.A.2.a.
238. Insulation Corp. of Am. v. Brobston, 667 A.2d 729, 731-32 (Pa. Super. Ct. 1995).
239. *Id.* at 731-32 (emphasis added).
240. *Alliance Metals*, 222 F.3d at 902.
241. Key Temp. Personnel, Inc. v. Cox, 884 P.2d 1213 (Okla. Ct. App. 1994).
242. *Id.* at 1217.

of the employment relationship. In rejecting Cox's defense, the court placed emphasis on the fact that, "it was Cox herself, that [sic] terminated her employment with Key."[243] Additionally, the court emphasized that Cox could not point to any contractual language that would allow her to escape the non-solicitation restriction if the work conditions were intolerable.[244] The court gave no credence to the fact that a constructive discharge is akin to a termination without cause, or that fairness and reasonableness may militate against enforcement of the restrictive covenant in such cases.[245]

c. Analysis

Viewing *Alliance Metals* as an anomaly, and *Cox* as simply a poorly reasoned decision, the constructive discharge analysis should almost always parallel the termination without cause analysis. If a state's restrictive covenant law provides that a termination without cause voids a non-compete, then an employee's claim that he was constructively discharged should give him an opportunity to void the non-compete clause.[246] A case following this approach is *International Business Machines Corp. v. Martson.*[247] In that case, which addressed an employee's forfeiture of benefits for violating a restrictive covenant, a federal district court in New York granted an employee leave to amend his answer so that he could raise the issue of constructive discharge in his efforts to avoid the covenant not to compete.[248] The court recognized that, under New York law, a termination without cause automatically voids a non-compete clause, and that constructive discharge is for all intents and purposes a termination without cause.[249]

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243. *Id.*

244. *Id.*

245. The decision is also somewhat unusual since Oklahoma is a pro-employee state, and the governing statute permits non-competition clauses in only two circumstances: sale of goodwill and dissolution of a partnership. *See* Loewen Group Acquisition Corp. v. Matthews, 12 P.3d 977, 980 (Okla. Ct. App. 2000) (voiding covenant not to compete in connection with business purchase; citing two statutory exceptions to prohibition on restraints of trade).

246. *Cf.* Tennyson v. Sch. Dist of Menomonie Area., 606 N.W.2d 594, 602 (Wis. Ct. App. 1999) (employee had claim for breach of contract, which employer could only terminate "for cause,"; constructively discharged); Guiliano v. Cleo, Inc., 995 S.W.2d 88, 95-96 (Tenn. 1999) (employer breached employment contract providing that executive could be terminated only "for cause" when it removed duties and constructively discharged him); Turner v. Anheuser-Busch, Inc., 876 P.2d 1022, 1030 (Cal. 1994) (stating that "[a]n employee may prove . . . that a constructive discharge is a breach of an express or implied contract of employment.").

247. International Bus. Machs. Corp. v. Martson, 37 F. Supp. 2d 613 (S.D.N.Y. 1999).

248. *Id.* at 619-21.

249. Post v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 397 N.E.2d 358, 360-61 (N.Y. 1979).

3. Assignment of Contract to New Employer

Many employees accept positions with companies based on their relationship with, and regard for, a management team that is in place at the time of hiring. Indeed, most employees devote little thought to succession planning and whether current management is looking to sell the business to a new owner. When a business is sold, however, the employee and acquiring corporation may have different expectations with respect to workforce stability. First, the employee may believe, especially in a closely-held company, that a sale of the business fundamentally alters the nature of the employment relationship, so that it is reasonable for her to examine other competitive job opportunities. Second, the acquiring corporation likely has conducted due diligence to determine whether the current sales or information technology staff is bound by restrictive covenants. The presence of strong covenants not to compete can dramatically affect the goodwill component of a business and can help ensure that new management will have a strong staff of key employees to effectuate the transition.

This tension is almost always resolved in the acquiring corporation's favor. Most well-drafted employment contracts contain an assignability clause, which permits an employer to assign a restrictive covenant in a business sale. The general rule is that, if a contract expressly permits a party to assign its rights under the contract, the assignee (the acquiring corporation) may enforce the agreement and any restrictive covenants contained therein.[250]

In the absence of an assignability clause, the authorities are split. Virtually all jurisdictions, including the employee-friendly states of Illinois and New York, have held that an assignment of a restrictive covenant to an acquiring corporation is permissible in the absence of a governing contractual clause.[251] However, Pennsylvania has held that, absent a specific contractual provision, restrictive covenants are not assignable to an acquiring corporation.[252]

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250. Barnes Group, Inc. v. Reinhart, No. TH 00-311-CTH, 2001 WL 301433 at *21 (S.D. Ind. Feb. 26, 2001); Hamer Holding Group, Inc. v. Elmore, 560 N.E.2d 907, 913 (Ill. App. Ct. 1990).

251. AutoMed Techs., Inc. v. Eller, 160 F. Supp. 2d 915, 923-24 (N.D. Ill. 2001); Artromick Int'l, Inc. v. Koch, 759 N.E.2d 385, 386-88 (Ohio Ct. App. 2001); Managed Health Care Assocs., Inc. v. Kethan, 209 F.3d 923, 929 (6th Cir. 2000); J. H. Renarde, Inc. v. Sims, 711 A.2d 410, 413 (N.J. Super. Ct. Ch. Div. 1998); Hexacomb Corp. v. GTW Enters., 875 F. Supp. 457, 464 (N.D. Ill. 1993); Herring Gas Co., Inc. v. Whiddon, 616 So. 2d 892, 896-97 (Miss. 1993); Special Prods. Mfg., Inc. v. Douglass, 553 N.Y.S.2d 506, 509 (N.Y. App. Div. 1990); Saliterman v. Finney, 361 N.W.2d 175, 178 (Minn. Ct. App. 1985).

252. Siemens Med. Solutions Health Servs. Corp. v. Carmelengo, 167 F. Supp. 2d 752, 757-58 (E.D. Pa. 2001).

If an employee is genuinely concerned about a management buy-out, he can always attempt to contract around the assignability clause by providing that a change of control will relieve him from the restrictive covenant. However, many employers realize that the goodwill value of the business, and concomitantly, the purchase price, will be significantly reduced if there is a threat of post-employment competition and customer raiding by key employees. Therefore, unless a valued prospective employee has true bargaining power, it is unlikely that he will be able to contract around assignability.

IV. PRACTICAL ADVICE FOR AVOIDING LEGAL DISPUTES

Given the myriad rules and tests that courts have employed in discharge cases, it is far more efficient for the employer and employee to address the enforceability of a restrictive covenant in the event of involuntary termination through a clear, well-drafted agreement. The ideal approach to define the parties' rights, obligations, and more importantly, avoid litigation, is to draft an employment agreement that addresses the enforceability of a covenant upon termination. Alternatively, if the employer seeks to discharge the employee, but fails to secure a non-compete, or the employment contract does not specifically address involuntary discharge with respect to the covenant, then the parties should provide for a brand new covenant, if desired, in a separation agreement.

A. *Addressing Involuntary Termination in the Employment Agreement*

Most employment agreements fail to make a distinction as to how a restrictive covenant is to operate when the employee is discharged, whether for cause or without cause. Instead, most contracts place resignation and termination for any reason together in one governing clause. The fundamental problem with this approach is that a court may invalidate the covenant in a case where the employee is terminated, regardless of how well the company lawyer drafts the contract. Perhaps the reason that so many covenants fail to differentiate between resignation, termination for cause, and termination without cause, is that an employee is rarely given the opportunity to suggest changes or modifications to the employment contract. The contracts are essentially take-it-or-leave-it documents distributed to all employees that the company seeks to bind to some form of post-employment restriction.

These 'employer-friendly' agreements, however, may not protect the employer's interests and may lead to judicial invalidation of the

contract. Given the reluctance of many courts to enforce non-competition provisions in involuntary discharge cases, an employer should address the issue specifically in an employment contract. The following steps, if adhered to, can provide an employer and employee with a clear understanding of the interplay between the employment separation and the enforcement of restrictive covenants, give the parties flexibility in the event a separation does in fact occur and, perhaps most importantly, survive judicial scrutiny.

1. Step 1 - Define "Termination for Cause"

The first step in drafting an effective restrictive covenant provision is to separate terminations for cause from those without cause. Rather than relying on a judicial construction of what 'cause' should encompass, it should be clearly defined in the contract. For instance, a contract could include the following provisions:

> Sec. 1. Under this Agreement, "cause" shall be defined as follows: (a) conviction of, or plea of *nolo contendre*, to a felony or other crime involving moral turpitude; (b) fraud, material dishonesty, embezzlement, or other material misappropriation of property by the Employee; (c) willful neglect of a defined duty or malfeasance; (d) willful failure to comply with the provisions of this Agreement, including [section defining job duties]; or (e) willful failure to comply with the reasonable and lawful instructions of the Board of Directors.[253]
>
> Sec. 2. If the Company terminates the employee for "cause," as defined herein, the Company must: (a) provide written notice to the Employee that the termination is for "cause," setting forth in reasonable detail the nature of such "cause"; and (b) if "cause" is for a reason set forth in Section 1(c), (d) or (e), give the Employee a reasonable opportunity to cure the asserted non-compliance or failure to perform, unless the Company determines in good faith that it would be futile to provide the Employee with such opportunity to cure.

The failure of an employer to give an employee notice would constitute an admission that the employee was terminated without cause. This may lead to unanticipated consequences, such as the triggering of rights to a company severance plan or unemployment compensation. Therefore, the employer must give proper notice of a termination for cause. If the reason for cause were a failure to perform a duty under the contract, then it would be in the best interests of all involved parties if the employee were able to cure the deficiency. However, an employer may claim that an opportunity to cure was futile and was

253. Depending on the contract and the employee's position in the company, other reasons may be delineated specifically.

therefore not warranted if the employee had repeatedly breached his duties in the past or if the breach was so severe as to impair company goodwill, destroy a client relationship, or otherwise constitute serious insubordination.

2. Step 2 - Equate Termination for Cause with Resignation

The next step is to draft a restrictive covenant that is triggered by a voluntary resignation *and* a termination for cause. A sample of an effective non-competition provision is the following:

> Sec. 3. In the event the Employee voluntarily resigns his employment with the Company or is terminated by the Company for "cause," as defined in Section 1, Employee covenants that he will not, directly or indirectly, whether as a principal or as a director, officer, employee, independent contractor, agent, partner, or stockholder to another entity (other than by the ownership of a passive investment interest of not more than 2.5% in a company with publicly traded securities), render any [define nature of services to be restricted, *e.g.*, medical, accounting] services to any person or entity within the Restricted Area for a period of one (1) year from the date of such resignation or termination ("the Noncompetition Term"). For purposes of this Section 3, "Restricted Area" is defined as [define desired geographical restriction].

3. Step 3 - Provide for a Restrictive Covenant in the Event of Termination Without Cause

The third, and most important, step is to set forth what will happen with respect to a restrictive covenant when an employee is discharged *without cause*. The vast majority of employment contracts ignores this step and, instead, groups all employment separations together, which could lead to judicial invalidation of a restrictive covenant if the termination was not for good cause. Using these model provisions, any termination that does not meet the definition of 'cause,' or for which no notice was provided to the employee, will be interpreted as without cause. To secure the validity of a non-compete clause in the event of a termination without cause, the following three sections should be included in the contract:

> Sec. 4. In the event the Employee is terminated by the Company without cause, Employee covenants that he will not, directly or indirectly, whether as a principal or as a director, officer, employee, independent contractor, agent, partner, or stockholder to another entity (other than by the ownership of a passive investment interest of not more than 2.5% in a company with publicly traded securities), render any [define nature of services to be restricted, *e.g.*, medical, accounting] services to any person or entity within the Restricted Area (as defined above) for a period of one (1) year from

the date of such termination. This Section 4 is subject to the provisions of Sections 5 and 6.

Sec. 5. The Company may elect, in its sole discretion, to enforce the provisions of Section 4 herein, provided that, if the Company so elects, following the date of the Employee's termination without cause, the Company shall, during the Noncompetition Term: (i) notify the Employee in writing within three (3) days of the effective date of termination of its election to enforce the provisions of Section 4; (ii) pay the Employee 50% of the Employee's base salary in monthly installments, at the rate existing as of the date of his termination; and (iii) provide the Employee with the same health insurance and life insurance benefits that he was receiving as of the date of his termination, with no cost to the Employee.

Sec. 6. In the event the Company elects to cease making payments and benefits to the Employee under Section 5 at any time during the Noncompetition Term, it shall provide the Employee notice of such election and the last date on which the Employee will receive payments and benefits under Section 5 ("the Termination of Payments Date"). The Company must provide such notice in writing at least thirty (30) days in advance of the Termination of Payments Date. If the Company makes such an election and provides the Employee with such notice, the Employee's obligations under Section 4 shall cease on the Termination of Payments Date, and the Noncompetition Term shall expire.

4. Analysis

Now that the employer has a contract that differentiates between a termination with cause and one without cause, while allowing it to enforce a restrictive covenant in both cases, will the covenant be enforced? In *Markovits v. Venture Info Capital, Inc.*,[254] the subject employment agreement contained variations of the provisions as set forth above. The court, applying Massachusetts's law, upheld the covenant as reasonable when the employee was terminated without cause.[255] The court reasoned that the employment agreement and a stock agreement, under which the company had bought back Markovits' stock, were "designed in such a manner that a former employee will be financially supported regardless of the manner of his termination."[256]

Although the stock buy-back was a significant financial boon to Markovits, the court did not analyze any other factors with respect to his termination and did not condition its finding of reasonableness on the stock buy-back. If an employer uses a model contract such as that

254. Markovits v. Venture Info. Capital, Inc., 129 F. Supp. 2d 647 (S.D.N.Y. 2001).
255. *Id.* at 660.
256. *Id.*

described above, and similar to that addressed in *Venture Info Capital*, the amount of consideration to be provided to an employee in the event of termination without cause will undoubtedly vary from case to case. Assuming the employer and employee engage in good faith negotiations, the amount of required consideration will depend on the likelihood that the employee can find work in another industry until his non-compete expires, whether he must relocate to another geographic area to find comparable employment, and the degree to which the employee can impair goodwill and customer relationships if he were to leave and compete. In the final analysis, the fact that the parties bargain for continued benefits after termination is a clear indicator of reasonableness and will most likely allow a court to uphold the covenant. If is critical that the employer and employee bargain beforehand for a form of automatic severance that is tied to a restrictive covenant. Using this flexible approach, the employer has the option either to enforce the covenant or let the employee compete and receive nothing upon discharge. Most importantly, this bargaining process will help avoid costly, unpredictable litigation.

B. *Negotiating the Separation Agreement*

In the vast majority of cases where an employer and employee have failed to agree beforehand to a termination contingency, the parties are still left with an option more palatable than litigation: including the restrictive covenant in the separation agreement. This approach does give the parties some flexibility. For instance, payments in exchange for a restrictive covenant can be spread out over periods of time to maximize the tax benefits to the employee without harming the employer; the employer can create a combination of other benefits, such as covering the cost of COBRA for a period of time, vesting or granting certain stock options, or providing outplacement services, among a host of alternatives. This may allow the parties to consider an employee's unique circumstances, which may not be predictable at the time the employer and employee *begin* an employment relationship. Accordingly, the employer must provide the employee with consideration for the covenant, something to which he is not already entitled upon severance, such as payment under an ERISA-based severance plan or accrued, but unpaid, bonuses.

Clearly, a restrictive covenant entered into between the parties as part of a settlement or separation agreement satisfies the ancillarity

requirement.[257] In fact, as the Supreme Court of Texas noted in *Justin Belt Co., Inc. v. Yost*, not only is it ancillary to a valid contract, but is also "ancillary to an agreement highly favored by the courts."[258] To this end, the reasonableness of the covenant should be subject to a less exacting degree of scrutiny. From the employer's perspective, the downside of negotiating a restrictive covenant as part of a separation agreement is uncertainty. Presumably, the employer is concerned about post-employment competition, but there is no way of telling what a disgruntled employee, or his lawyer, is going to seek for the non-compete, particularly if he has a viable claim for discrimination or wrongful discharge. A company's 'low-ball' offer may invite a threat of litigation by the employee. If the former employee has another competitive opportunity lined up, he can always pursue a declaratory judgment action to determine whether the covenant contained in his employment contract is void in light of the involuntary discharge.

The major problem from the employee's perspective is the absence of leverage after termination. The employee will most likely want to complete a deal quickly, in the hopes of securing some payment, or insurance coverage, to tide him over until he can find new work. Moreover, if the former employee calls the employer's bluff and seeks to compete on his own, he runs the risk of getting sued by the employer for violating the covenant, a claim that may or may not have merit. Very few jurisdictions have any predictable rules, and the employer may determine that its trade secrets, customer relationships and goodwill are valuable enough to try and protect through litigation.

An employee could face a challenge *even if* he never executed a restrictive covenant while employed.[259] Of course, a court will not use the implied covenant of good faith and fair dealing to create what amounts to an *ex post facto* non-compete or non-solicit clause.[260] However, the employer could pursue a trade secrets claim, arguing that the employee's new position will inevitably lead to the disclosure

257. *See* Justin Belt Co., Inc. v. Yost, 502 S.W.2d 681, 684 (Tex. 1973) (upholding restrictive covenant in settlement agreement).

258. *Id.*

259. *See* Long v. Atlantic PBS, Inc., 681 A.2d 249, 253 (R.I. 1996) (stating that "absent any enforceable noncompetition agreement, former employees . . . can solicit their previous employer's customers for business, *as long as*, in doing so, they are not acting tortiously, for example, by interfering unjustifiably with their former employer's contracts, by misappropriating the employer's trade secrets, or by converting other confidential business information belonging to their former employer.") (emphasis added).

260. *See* Prudential Ins. Co. of Am. v. Sempetrean, 525 N.E.2d 1016, 1021 (Ill. App. Ct. 1988) (holding that absent a restrictive covenant or some badge of fraud, a former employee may compete with his former employer and solicit former customers without breaching any implied covenants of good faith).

of trade secrets that the employee has previously learned.[261] While the law is relatively undeveloped with respect to "inevitable disclosure" in the context of employees who do not operate under non-competition clauses, the trend appears to disapprove of such a theory, so that the employee is allowed to engage in post-employment competition.[262] Courts have made it clear that the "umbrella of trade secret protection should not be deployed to suppress legitimate competition," so an employer must consider what the actual threat really is before pursuing the employee on this basis.[263] For example, if the employer pursues a trade secrets claim in bad faith to dissuade the employee from competing, it may be liable to the employee for his attorneys' fees in defending such a suit.[264] Nevertheless, an employer could sue a former employee for tortious interference with contract if he attempts to solicit business from customers of the company.[265] While the law does afford a competitor a qualified privilege to compete in the relevant marketplace, a departed employee still cannot use wrongful means to compete with his former employer.[266] Some employers attempt to dissuade prospective employers from dealing with the discharged worker by informing them that the employee is subject to a non-compete agreement, and that the new employer may be lia-

261. *See* PepsiCo, Inc. v. Redmond, 54 F.3d 1262, 1269 (7th Cir. 1995) (applying inevitable disclosure of trade secrets doctrine even when employee never signed non-compete covenant); Matthew K. Miller, Note, *Inevitable Disclosure Where No Non-Competition Agreement Exists: Additional Guidance Is Needed*, 6 B.U. J. SCI. & TECH. L. 9, 38-49 (Spring 2000) (discussing the doctrine of inevitable disclosure as well as its application where employee has no non-compete covenant).

262. *See* Complete Bus. Solutions, Inc. v. Mauro, No. 01 C 0363, 2001 WL 290196 at *5 (N.D. Ill. Mar. 16, 2001) (stating that in "cases that have successfully applied the 'inevitable disclosure' doctrine, the employee had agreed that he would not compete with his former employer for a fixed period of time . . .").

263. 3M Co. v. Pribyl, 259 F.3d 587, 595 n.2 (7th Cir. 2001); *cf* Zep Mfg. Co. v. Harthcock, 824 S.W.2d 654, 663-64 (Tex. Ct. App. 1992) (action against new employer for tortuous interference with contract cannot be predicated on underlying non-compete that is invalid).

264. *See* Telephone Mgmt. Corp. v. Gillette, No. CV 99-1338-KI, 2001 WL 210179, at *3 (D. Or. Feb. 20, 2001) (awarding attorneys' fees to fired employee in trade secret litigation when company brought claim in bad faith and could not articulate what trade secrets ex-employee had misappropriated).

265. *Cf. Harthcock*, 824 S.W.2d at 663-64 (discussing that tortuous interference with contract claim requires an employer to prove: (1) a contract; (2) a willful and intentional act that interferes with the contract and was calculated to cause damage to the employer; and (3) actual damages).

266. *See* Times Herald Co. v. A.H. Belo Corp., 820 S.W.2d 206, 215 (Tex. Ct. App. 1991) (noting that a party may cause a customer to terminate a terminable-at-will contract with the competitor and may obtain the future benefits for the party's own competitive advantage by offering better contract terms or a higher price); RESTATEMENT (SECOND) OF TORTS: COMPETITION AS PROPER OR IMPROPER INTERFERENCE § 768 (1979) (setting forth elements of competitor's privilege).

ble for tortious interference with contract, or prospective advantage, if they enable the departed employee to solicit new business.[267] However, former employers cannot blithely assert that a departed employee is bound by a restrictive covenant, if he in fact is not, and may be subject to an injunction prohibiting such misleading representations.[268]

The very fact that an employee has been terminated, in conjunction with his attempts or threats to compete with his former employer, may make negotiating a separation agreement contentious and difficult. As set forth above, myriad issues arise regarding post-employment competition, even when no clear restrictive covenant is at issue. Litigation, or at the very least threats of litigation, may parallel discussions surrounding the separation document. To be sure, this usually is not an environment that invites a fair, evenhanded resolution. While executing a restrictive covenant as part of a separation agreement may be more attractive than litigating the enforceability of a previously-executed covenant in an employment agreement, this approach is fraught with uncertainty and is not nearly as effective as addressing the enforceability of the covenant in the employment contract.

V. CONCLUSION

In examining covenants not to compete in the context of an involuntary termination, courts should employ a balancing of the equities approach to give consideration to the nature of the discharge in conjunction with all other relevant factors. For cause/without cause distinctions and categorical rules are inflexible, and their application inevitably leads the parties into a collateral dispute as to a discharged employee's work history. The involuntary termination cases analyzed herein have yielded some bizarre results and poorly reasoned opinions. Employers and their attorneys should seek to avoid these disputes, since it is unpredictable how a court might ultimately rule, or even what analysis it might apply. The soundest approach is to provide, at the inception of the employment relationship, what happens to a restrictive covenant when the employee is fired. If drafted properly, the employment contract can give the company an option to en-

267. *See* Automated Concepts Inc. v. Weaver, No. 99 C 7599, 2000 WL 1134541 at *5-7 (N.D. Ill. Aug. 9, 2000) (finding that former employer stated a tortious interference with contract claim against new employer relating to employee non-compete agreement).

268. *See* Amalgamated Acme Affiliates, Inc. v. Minton, 33 S.W.3d 387, 392-96 (Tex. Ct. App. 2000) (affirming trial court's entry of temporary restraining order barring former employer from falsely asserting that departed employee was subject to non-compete agreement; constitutional prohibition against "prior restraints" on speech not applicable to false and deceptive business practices).

force the restrictive covenant in exchange for severance, or simply let the employee walk away free and clear. While certainly more equitable from the terminated employee's perspective, this approach gives the employer the opportunity to assess and quantify the competitive threat posed by the discharged worker without committing itself to a particular course of action.