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Validity of Nonsolicitation Clauses in Employment Contracts

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VALIDITY OF NONSOLICITATION CLAUSES IN EMPLOYMENT CONTRACTS

Introduction

Historically, Louisiana courts have been opposed to the enforcement of agreements in restraint of trade or competition.[1] The courts strictly construe agreements restricting competition whether the agreement is in the form of restrictions on competition by a former employee, restrictions on competition by the seller of a business, or some variation of agreement which has the effect of limiting competition. This comment will address one variation of non-competition clauses: clauses prohibiting solicitation of customers by an employee upon termination of the employment relationship.

The current trend of Louisiana courts is to view "nonsolicitation of customers" clauses as restrictions on competition by a former employee under Louisiana Revised Statutes (La. R.S.) 23:921, which provides:

> No employer shall require or direct any employee to enter into any contract whereby the employee agrees not to engage in any competing business for himself, or as the employee of another, upon the termination of his contract of employment with such employer, and all such contracts, or provisions thereof containing such agreement shall be null and unenforceable in any court, provided that in those cases where the employer incurs an expense in the training of the employee or incurs an expense in the advertisement of the business . . . the employee is permitted to agree and bind himself that at the termination of his or her employment that said employee will not enter into the same business that employer is engaged over the same route or in the same territory for a period of two years.[2]

The underlying purpose of this statute is to protect an employee from being deprived of his right to earn a better living by having the opportunity to freely leave his present employment in search of a better job which may require the skills he has developed from prior work experience.[3] Therefore, non-competition agreements which have the effect

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1. See Standard Brands, Inc. v. Zumpe, 264 F. Supp. 254 (E.D. La. 1967); National Oil Service Inc. v. Brown, 381 So. 2d 1269 (La. App. 4th Cir. 1980); Target Rental Towel, Inc. v. Byrd, 341 So. 2d 600 (La. App. 2d Cir. 1977).

2. La. R.S. 23:921 (1985).

3. Orkin Exterminating Co. v. Foti, 302 So. 2d 593, 597 (La. 1974).

of tying an employee to his present employment are against public policy.[4]

However, unlike a non-competition agreement where an employee is absolutely prohibited from competing against his former employer within a certain area, a "nonsolicitation of customers" clause allows the employee to compete directly against the former employer with the exception of soliciting a limited number of customers with whom the employee previously dealt on behalf of the employer. While the employee has a right to self-improvement through job mobility, an employer may have a competing interest in the protection of his customers from competition by an employee who is the employer's only contact with those customers. In this situation the employee may gain influence over the customers through regular contact away from the office, allowing him to easily divert the customers from his former employer.

The courts will likely reach a more equitable result if "nonsolicitation of customers" clauses are interpreted in light of all the circumstances of each case with due regard for the competing interests of the employer, the employee, and society, rather than interpreting these limited restrictions on competition under La. R.S. 23:921.

Before consideration of the enforceability of "nonsolicitation of customers" clauses, the history of non-competition agreements ancillary to employment contracts as well as the history of nonsolicitation clauses is discussed. The historical analysis also includes a discussion of La. R.S. 23:921. The comment then addresses some alternative approaches of how courts can determine the validity of nonsolicitation clauses to achieve an equitable balance between the conflicting interests of the employer, employee, and public.

History of Non-Competition Agreements

Prior to 1934, decisions declaring non-competition agreements in employment contracts invalid were uncertain as to the grounds for nullity.[5] In 1934 the legislature tried to bring consistency to the interpretation of non-competition clauses.[6] Act 133 of 1934 (now La. R.S. 23:921) provided an absolute prohibition of agreements restricting competition by a former employee after termination of employment.[7] The

4. Id.

5. Most decisions used the doctrine of serious consideration to find non-competition agreements invalid. See Cloverland Dairy Prod. Co. v. Grace, 180 La. 694, 157 So. 393 (1934); Blanchard v. Haber, 166 La. 1014, 118 So. 117 (1928); see also Comment, Agreements Not to Compete, 33 La. L. Rev. 94, 98-99 (1972).

6. 1934 La. Acts No. 133, codified as La. L. Rev. 94, 98-99 (1972).

7. Id.

act was a strong indication that non-competition agreements in employment contracts were not favored in Louisiana.

Certain judicially created exceptions developed despite the broad prohibitory language of Act 133. The exceptions fit under one of three categories: (1) solicitation of customers or employees, (2) use of customer lists, and (3) use of trade secrets.[8] The development of these exceptions reveals the difficulty the courts faced in an effort to balance the competing interests of the employer and employee while also keeping in mind the public welfare.[9]

In 1962 the legislature amended La. R.S. 23:921 to allow an exception to the prohibition of non-competition agreements when the employer had expended money in training the employee or in advertising the business.[10] Courts struggled over how to properly interpret the legislature's intent in amending the statute. The courts were not sure what the legislature intended by the phrase "where the employer incurs an expense in the training of the employee or incurs an expense in the advertising of the business that the employer is engaged in."[11] There was controversy among the circuits as to what amount of expenditures was adequate to support a non-competition agreement.[12]

The supreme court, in *Orkin Exterminating Co. v. Foti*,[13] determined that it would uphold a "non-competition agreement only where substantial funds were spent in special training or in special advertisement of the employee himself (rather than generally of the business)."[14] The

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8. Comment, supra note 5, at 100. The employer's right to protection from the use of customer lists and trade secrets is beyond the scope of this article. See Standard Brands, Inc. v. Zumpe, 264 F. Supp. 254 (E.D. La. 1967) (breach of faith for former employee to disclose confidential information gained through employment); NCH Corp. v. Broyles, 749 F.2d 247 (5th Cir. 1985) (violation of La. R.S. 51:1405 for former employee to use confidential collection of customers in routebook created by employer). For a detailed discussion of an employer's right to protect customer lists and trade secrets, see 2 R. Callmann, Unfair Competition Trademarks and Monopolies (4th ed. 1981).

9. For a good discussion on the competing interests of society, employees, and employers, see Blake, Employee Agreements Not to Compete, 73 Harv. L. Rev. 625 (1960); Comment, Post-Employment Restraint Agreements: A Reassessment, 52 U. Chi. L. Rev. 703, 712-25 (1985).

10. 1962 La. Acts 104.

11. La. R.S. 23:921 (1985).

12. The first circuit held that ordinary training expenses incident to employment were sufficient to meet the limited exception under La. R.S. 23:921. Aetna Finance Co. v. Adams, 170 So. 2d 740 (La. App. 1st Cir. 1964), writ denied, 247 La. 489, 172 So. 2d 294 (1965). Conversely the third circuit interpreted the statute as requiring substantial expenditures to support a non-competition agreement. National Motor Club v. Conque, 173 So. 2d 238 (La. App. 3d Cir.), writ denied, 247 La. 875, 175 So. 2d 110 (1965).

13. 302 So. 2d 593 (La. 1974).

14. Id. at 595-96.

court stated that the 1962 amendment [15] "provides only a limited exception to the stringent prohibition of the statute against such non-competition agreements, and to the strong and long-established public policy of this state to such effect."[16]

History of Nonsolicitation Agreements

In *Martin-Parry Corp. v. New Orleans Fire Detection Service*,[17] decided in 1952, the Louisiana Supreme Court recognized that nonsolicitation agreements do not have the effect of restricting competition in violation of La. R.S. 23:921. *Martin-Parry* dealt with an agreement whereby the employee agreed not to solicit or interfere with the owner's employees and dealers after termination of his employment. The court held the agreement was enforceable and characterized the agreement not to solicit *employees* or *dealers* as very different from agreements restricting competition in general, which are contrary to public policy.[18] The holding in *Martin-Parry* effectively puts agreements by an employee not to solicit his former co-employees outside of the statutory restrictions for non-competition agreements.[19]

In *National Motor Club v. Conque*,[20] Judge Tate, writing for the Louisiana Third Circuit Court of Appeal, distinguished the holding in *Martin-Parry*. The court held that a contract prohibiting an employee from selling memberships for a competitor to the company's customers upon termination of employment was prohibited by La. R.S. 23:921, unless the agreement was supported by substantial training or advertising expenses.[21] Judge Tate reasoned that an agreement not to raid the employer's staff and dealerships is not a restriction on competition, while a clause prohibiting solicitation of the employer's customers in effect prohibits the employee from engaging in competition with the employer.[22]

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15. 1962 La. Acts 104.

16. *Foti*, 302 So. 2d at 596.

17. 221 La. 677, 60 So. 2d 83 (1952).

18. Id. at 683, 60 So. 2d at 85. It should be noted that the case did not address the issue of nonsolicitation of "customers."

19. See John Jay Esthetic Salon, Inc. v. Woods, 377 So. 2d 1363 (La. App. 4th Cir. 1979); La. R.S. 23:921 (1985).

20. 173 So. 2d 238 (La. App. 3d Cir. 1964), writ denied, 247 La. 875, 175 So. 2d 110 (1965).

21. Id. at 243-44. See also Napasco Int'l Inc. v. Maxson, 420 So. 2d 1276 (La. App. 3d Cir. 1982); Orkin Exterminating Co. v. Broussard, 346 So. 2d 1274 (La. App. 3d Cir.), writ denied, 350 So. 2d 902 (La. 1977).

22. *National Motor Club*, 173 So. 2d at 244.

The Louisiana Second Circuit Court of Appeal in *Delta Finance Co. v. Graves*[23] took a different stance and upheld an employment contract containing a provision which prevented the employee from soliciting any active or paid out customers of the employer.[24] The court stated: "The contract of which Graves complains does not prohibit his employment in a business competitive with the employer and thereby conflict with LSA-R.S. 23:921, but only enjoins him not to solicit any active or paid out customers of Delta. . . ."[25]

Both the fourth and fifth circuits have adopted the rationale that "nonsolicitation of customers" clauses must be supported by substantial expenditures on the employee for training or advertising.[26] The fourth circuit reached this conclusion in *In re Standard Coffee Service Co. v. Pries*[27] after it had earlier indicated that agreements prohibiting solicitation of the employer's customers would not be prohibited under La. R.S. 23:921.[28]

Currently, Louisiana's third, fourth, and fifth circuits will uphold agreements in employment contracts restraining employees from soliciting the employer's customers only when the "substantial expenditures" test is met under La. R.S. 23:921.[29] The first circuit has yet to decide the issue while the second circuit has held that nonsolicitation of customers clauses are not prohibited by the statute.[30] Despite the conflict among the circuits, the supreme court has not addressed the issue.[31]

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23. 180 So. 2d 85 (La. App. 2d Cir. 1965).

24. Id.

25. Id. at 88.

26. *National Motor Club,* 173 So. 2d 238. For cases following *National Motor Club,* see In re Standard Coffee Service Co. v. Preis, 499 So. 2d 1314 (La. App. 4th Cir. 1986), writ denied, 501 So. 2d 232 (La. 1987); "Bugs" Burger Bug Killers v. Keiser, 463 So. 2d 45 (La. App. 5th Cir. 1985); Alexander & Alexander, Inc. v. Simpson, 370 So. 2d 670 (La. App. 4th Cir.), writ denied, 371 So. 2d 836 (La. 1979); Orkin Exterminating Co. v. Broussard, 346 So. 2d 1274 (La. App. 3d Cir. 1977).

27. 499 So. 2d 1314 (La. App. 4th Cir. 1986).

28. See National Oil Service, Inc. v. Brown, 381 So. 2d 1269, 1273; (La. App. 4th Cir. 1980) (court showed willingness to uphold nonsolicitation of customers clause as exception to La. R.S. 23:921, but no such covenant was proved). It may be worthy to note that the *National Oil Service* opinion was written by Judge Lemmon who is now a Justice on the Louisiana Supreme Court.

29. See cases cited supra note 27.

30. Delta Finance Co. v. Graves, 180 So. 2d 85 (La. App. 2d Cir. 1965).

31. See Commonwealth Life Ins. Co. v. Neal, 669 F.2d 300, 306 (5th Cir. 1982), where the court was of the opinion that the Louisiana Supreme Court would decide the issue by holding that agreements restricting solicitation of customers are restraints on competition in violation of La. R.S. 23:921. See also NCH Corp. v. Broyles, 749 F.2d 247 (5th Cir. 1985).

Customers as a Protectible Interest

Louisiana courts have closely examined various types of restrictive clauses in employment contracts.[32] This scrutiny reflects the strong public policy in favor of preserving an individual's right to freedom and to self-improvement through job mobility.[33] The policy reasons may be less compelling when an employee is restricted only from soliciting a discrete number of customers whose identity the employee learned as a result of his employment.[34] It is argued, however, that employers would attempt to use these nonsolicitation clauses to restrict competition in instances where they would otherwise be prohibited by La. R.S. 23:921.[35] Contravention of the statute can be prevented if the courts determine the true effect of clauses prohibiting solicitation of customers by a former employee. If the agreement is limited to a clearly defined group of customers and still permits an employee to pursue work in the same field by soliciting other customers in the area, the policy of the statute is not defeated.

The need for protection of the employer's customers will vary in all instances.[36] The general principle is that an "employer has a sufficient interest in retaining his present customers to support an employee covenant whenever the employee's relationship with customers is such that there is a substantial risk that he may divert all or part of their business."[37]

The court's decision to uphold a non-competition agreement involves balancing the competing interests of the employer, the employee, and the public welfare. At common law this balance is struck by determining the reasonableness of the restriction on competition.[38] An agreement not to compete will be upheld if the restrictions regarding duration and geographical extent are reasonable under the circumstances. Louisiana, however, has adopted the requirement that substantial sums be expended

32. See Johnson, Developments in the Law, 1979-1980 Obligations, Illegal Cause: Agreements Not to Compete, 41 La. L. Rev. 355, 358, 366 (1981).

33. See National Motor Club v. Conque, 173 So. 2d at 241.

34. See Johnson, supra note 33, at 363.

35. *National Motor Club*, 173 So. 2d at 244.

36. Annotation, Enforceability of Restrictive Covenant, Ancillary to Employment Contract, as Affected by Duration of Restriction, 41 A.L.R. 2d 71 (1955).

37. Blake, supra note 9, at 657.

38. 14 S. Williston, A Treatise on the Law of Contracts §1636 (3d ed. 1972). In determining what is reasonable, consideration should be given to: (1) Whether the promise is broader than that which is necessary to protect some legitimate interest of the promisee, (2) the effect of the promise on the promisor, and (3) the effect of the promise on the public. Id. See also Arthur Murray Dance Studios, Inc. v. Witter, 62 Ohio L. Abs. 17, 105 N.E. 2d 685 (1952).

by the employer in order to uphold non-competition agreements ancillary to an employment contract.[39]

In determining whether the employer has expended sums on the employee sufficient to support a non-competition agreement, the court will consider the length of time the employee has served the employer.[40] The longer the length of service, the more likely the court will find that the employer has already received the benefit of any investment made in the employee.[41] However, this test will not protect employers from former employees who have a competitive advantage since they have been personally affiliated with the customers for a long period of time.[42] These employers deserve greater protection since the long-term employee has gained the customer's confidence and can easily divert customers away from the employer. Therefore, as the employer's need for protection increases with the length of time an employee remains in his employ,[43] the court will be less inclined to afford the employer protection based on the theory that the employer has been compensated for any investment made through the employee's services.[44]

A more equitable test to determine the validity of agreements not to solicit the employer's customers would be to base an employer's right to protection on the basis of the customer contact theory.[45] The customer contact theory allows the courts to consider "(1) the frequency of the employee's contacts with customers and whether they are the employer's only relationship with those customers, (2) the locale of the contact, and (3) perhaps most important, the nature of the functions performed by the employee."[46] The courts will be more likely to uphold nonsolicitation of customers clauses when the employee has frequent contact with the customers away from the office and the employer's only relationship with the customer is through the employee.[47]

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39. La. R.S. 23:921 (1985).

40. See Orkin Exterminating Co. v. Foti, 302 So. 2d 593, 598 (La. 1974).

41. Id.

42. Annotation, supra note 37, at 73.

43. Id.

44. See *Foti*, 302 So. 2d at 598. The courts will protect an employer's customers when the employee is engaging in unfair competiton. See La. R.S. 51:1405 (1987); see also Dufau v. Creole Eng'g, Inc., 465 So. 2d 752 (La. App. 5th Cir. 1985) (soliciting employer's customers for employee's own business prior to termination of employment constituted unfair competition).

45. See Blake, supra note 9, at 658-67.

46. Id. at 659. See also Arthur Murray Dance Studios, Inc. v. Witter, 62 Ohio L. Abs. 17, 105 N.E. 2d 685 (1952) for a detailed discussion of the differing nature of possible customer contacts.

47. For a list of cases where the court applied the customer contact theory in upholding agreements by the employee not to solicit his former employer's customers, see Annotation, supra note 37, at 73-82.

Under this approach to the validity of "nonsolicitation of customers" clauses, the court is not faced with the problem of determining the reasonablesness of the territorial extent of restriction. If the agreement restricts the employee from soliciting only customers which the customer contact theory dictates, the concern that the restriction may be geographically too broad is eliminated.

The court will still be forced to determine the reasonableness of the duration of restriction. A reasonable duration of restriction is that period of time which is necessary to allow the employer to replace the former employee and to allow the new employee to become familiar with the customers in such a way that the employer can equally compete with the former employee to protect his business.[48] This general rule, however, provides little guidance for determining what should be the actual duration of restriction and inevitably leaves the court with wide discretion.

In order to avoid the possible inconsistency and confusion in determining what is a reasonable period to restrict an employee, Louisiana courts might look to La. R.S. 23:921, in which the legislature has expressly stated that non-competition agreements shall in no case exceed two years. Since nonsolicitation clauses are a limited form of restriction on the employee, it is arguable that the legislature would also limit these agreements to a maximum duration of two years as a matter of public policy. This limitation would give the employer limited protection while also helping insure that an employee does not enter into too burdensome an agreement.

The customer contact theory, however, ignores the fact that the goodwill generated in customers is largely relative to the skill and individual efforts of the employee. It is well recognized that it is in the public's best interest to allow an employee to use the skills and knowledge acquired during the ordinary course of prior work in his future employment.[49] Since the confidence gained in the customers is primarily the fruit of the employee's efforts, the employee should be free to utilize these fruits to his advantage in future employment.[50]

However, an employee will not be permitted to use the fruits of his prior employment when such fruits have resulted in a legitimate trade secret[51] of the former employer.[52] The Louisiana legislature rec-

48. See Annotation, supra note 37, at 73.

49. See Standard Brands, Inc. v. Zumpe, 264 F. Supp. 254, 259 (E.D. La. 1967).

50. See id. at 268; Restatement (Second) of Agency § 396 (1957); Blake, supra note 9, at 654-55.

51. La. R.S. 51:1431(4) (1987) defines trade secret as "information, including a formula, pattern, compilation, program, device, method, technique, or process, that: (a) derives independent economic value, actual or potential, from not being generally known

ognized the possible inequities that might result from the unfettered discretion of an employee to utilize all the fruits of his employment. This recognition resulted in the enactment of the Unfair Trade Practices and Consumer Protection Law and the Uniform Trade Secrets Act.[53] With respect to trade secrets, the courts have found it necessary to consider the circumstances of each particular case in order to balance the employee's right to individual freedom with the employer's right to protection of business assets.[54] While a customer list may or may not meet the statutory requirements of a trade secret, it may be an equally valuable corporate asset. Therefore, the validity of agreements to protect an employer's customers should also be determined by consideration of all the circumstances rather than by a "substantial expenditures" test under La. R.S. 23:921.

Restrictions on Competition to Protect Goodwill

Louisiana courts have recognized that non-competition agreements ancillary to the sale of an ongoing business are necessary to protect the goodwill purchased by the vendee. Therefore, these agreements are not contrary to public policy.[55] The courts apply the common law test of reasonableness in determining the validity of these agreements, considering the circumstances of each case.[56] However, Louisiana courts are unwilling to apply a "reasonableness test" to agreements where an employer seeks to protect his customers who are valuable assets in the form of goodwill of the business. Goodwill, the earning potential of a business gained through positive customer relations, quality products, superior management, or a combination of factors, is an intangible asset. If an employee is allowed to solicit his former employer's customers, the value of the employer's goodwill will be diminished as the earning potential of the business is decreased with the loss of each customer.

Arguably an owner's goodwill accumulated through years of business should be protected whether ancillary to a contract of sale or a contract of hiring. The Supreme Court of Wisconsin made no distinction of the interests to be protected in *Eureka Laundry Co. v. Long*.[57] It noted the

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to and not being readily ascertainable by proper means by other persons who can obtain economic value from its disclosure or use, and (b) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy."

52. See Wright Chemical Corp. v. Johnson, 563 F. Supp. 501, 505 (M.D. La. 1983); *Standard Brands*, 264 F. Supp. at 268-69.

53. La. R.S. 51:1401-18 (1978), and La. R.S. 51:1431-39 (1987).

54. See National Oil Service Inc. v. Brown, 381 So. 2d 1269 (La. App. 4th Cir. 1980).

55. See Moorman & Givens v. Parkerson, 131 La. 204, 59 So. 122 (1912).

56. Id. See also Comment, supra note 5, at 106-07.

57. 146 Wis. 205, 208-09, 131 N.W. 412, 413 (1911), noted in Carpenter, Validity of Contracts Not to Compete, 76 U. Pa. L. Rev. 244, 267-68 (1928).

necessity for the purchaser of a business to obtain a limited non-competition agreement from the seller in order to protect the goodwill established in the business. Protection is necessary to prevent the seller from using his influence and familiarity with customers to divert trade from the business until the buyer gains enough familiarity with the customers to protect his own interests.[58] The court analogized this situation to the protection of goodwill incident to an employment contract by stating:

> So the owner of an established business says to a prospective employee: 'In the employment you will become familiar with the customers of my business in a way that I cannot. You will meet them frequently, while I see them rarely, if ever. Now, I will hire you upon the express condition that you will agree for a limited length of time not to solicit trade from such of my customers as you may have supplied while in my employ. . . . At the end of that time my new employees will be sufficiently well acquainted with my customers to protect my business.'[59]

The distinction between covenants not to compete as either incidental to the sale of a business or incidental to a contract of employment should not be dispositive of the validity afforded such agreements.[60] "The ultimate question should be the same in both cases—what is necessary for the protection of the promisee's rights and is not injurious to the public."[61] Although there are also arguments against treating non-competition agreements incident to the sale of a business similarly to non-competition agreements in employment contracts,[62] the similar concern in the protection of goodwill as an acquired proprietary interest make it less objectionable to sustain a limited non-competition agreement related to an employment contract such as a nonsolicitation of customers clause.

Conclusion

Nonsolicitation of customers agreements do not have the effect of restricting competition and depriving the employee of the right to earn a living in all circumstances. The proper inquiry should be to determine the true effect of the agreement rather than simply construing all non-

58. 131 N.W. at 413.

59. Id.

60. 14 S. Williston, supra note 39, § 1643, at 148.

61. Id. at 150-51.

62. Sellers of businesses usually have a better bargaining position than an employee who may divest himself of his right to earn a livelihood with little thought of the consequences. See Carpenter, supra note 58, at 268.

solicitation agreements under La. R.S. 23:921 as restrictions on competition. If the Louisiana Supreme Court should rule that nonsolicitation of customers clauses are not within the broad prohibition of La. R.S. 23:921, there are several ways in which the court can insure that the long-established public policy against non-competition agreements will not be defeated.

The court could subject the employer to a heavier burden of proof in establishing his right to protection. This can be done by forcing the employer to prove the right to protection of his customers from a former employee in light of all the factors suggested by the customer contact theory.[63] In addition a nonsolicitation clause is much less restrictive than a general non-competition agreement. Therefore an employee is not deprived of a chance to earn a living with the particular skills he has acquired if the agreement is limited only to the extent necessary to protect the employer's interests in his customers. For example, an agreement by an employee to refrain from soliciting any customer of his former employer, regardless of whether the employee has had contact with the customer, is no doubt an overbroad restraint on competition. If the courts interpret nonsolicitation of customers clauses with consideration of all the particular circumstances involved, rather than subjecting these covenants to the "substantial expenditures" test under La. R.S. 23:921, a more equitable decision will be reached with due regard for the conflicting interests of the employer, employee, and public.

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63. See Blake, supra note 9, at 658-67; Annotation, supra note 37, § 15.