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Noncompete Contracts: Understanding the Cost of Unpredictability

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NONCOMPETE CONTRACTS: UNDERSTANDING THE COST OF UNPREDICTABILITY

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I. INTRODUCTION

The intention of this Article, and the brief presentation that accompanied it at the Texas Wesleyan University School of Law Symposium on The Role of Contract in the Modern Employment Relationship, is to highlight the need for a more uniform and consistent application of contract principles to noncompete contracts in order to increase predictability in this field of law.[1] Presently both employees and employers pay a heavy price due to increased uncertainty in this area. This is because courts use equitable concepts to circumvent basic contract law principles without recognizing the unseen price that is paid by others when contract-based predictability is eroded.

To illustrate this point, this Article will begin with six different scenarios that are very real possibilities under the current state of the law and highlight the practical cost to litigants in the current unpredictable environment. In addition to highlighting a significant problem created by the unpredictability in this area of employment contract law, this Article will also provide the practicing employment law attorney with a review of different contract options to consider when drafting noncompete contracts and similar protective agreements. In Part II, the nature of unpredictability in a number of key foundational concepts like protectable interests, consideration, and choice of law is examined. In Part III, an overview of advantages and disadvantages to the eight most common forms of restrictive contracts are covered to illustrate that no one contract option solves the present unpredictability problem and to provide the practicing attorney with a helpful checklist of contract options to consider. To conclude, a suggestion for a more balanced approach to improve predictability is provided.

A. *Illustrating the Cost of Unpredictability*

In order to understand the cost of unpredictability created by the current state of the law on noncompete contracts and other agreements against unfair competition, it is helpful to examine a number of likely scenarios. In the first scenario, you represent a company that is seeking to hire a marketing executive who recently left a competing company. Your company provided an offer letter to the prospective employee and you now learn, via a demand letter from the old employer, that the prospective employee signed a noncompete. You are

1. This Article is submitted for discussion purposes only and is not legal advice. The opinions expressed herein are solely those of the author and not those of Littler Mendelson P.C.

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in one of the majority of states where noncompete contracts are enforced under limited circumstances. You have the contract examined by outside counsel who advises that enforcement of the noncompete contract is unpredictable because it depends on how good a job the candidate's former employer did at protecting its trade secrets and how much of this information the candidate received. Your company does not want to take the risk of protracted litigation and turns the applicant away and hires another candidate. The prospective employee has lost a good job opportunity, and your company has lost its best candidate. The cautious approach is costly.

Scenario two is similar to scenario one, but seen from the employee's perspective. The employee quits a fairly stable job where he was unhappy because he is confident that he can quickly get a job elsewhere. He has signed a noncompete contract but is of the common belief that because this is a "right to work state,"[2] the noncompete will not be enforced. "Everyone knows those things are not enforceable," he tells a friend. Six months later he is still unemployed. The guesswork approach is costly.

Under scenario three, an employee of your company who is heavily involved in marketing and new product development leaves and goes to work for a competitor. You have no contracts in place because you are of the understanding that noncompete contracts are so widely disfavored that such contracts are largely useless. Three months later the competitor comes up with a marketing campaign that rivals what it took your company three years of trial and error to develop. You pursue a legal action but the court quickly rejects your inevitable disclosure of trade secrets argument, noting that if you wanted protection against this, you should have covered it with a noncompete contract; and the court will not make one for you after the fact.[3] The competitors' profitability shoots up, and your company's position sinks. Layoffs follow. Numerous employees lose their jobs. Again, the cautious and light-handed employer approach proves costly.

Under scenario four, a management-level employee with six successful sales employees under her supervision receives an attractive offer (i.e., big pay raise) to go to work for another company and develop a competing line of business. She talks to the six employees working under her who agree to go with her. She has a noncompete contract that she believes she can get set aside on legal grounds be-

2. In reality, the "right to work state" label refers to those states where an employee has the right to be employed without mandatory union membership and is frequently misunderstood.

3. *See* ConAgra, Inc. v. Tyson Foods, Inc., 30 S.W.3d 725, 730 (Ark. 2000) (faulting ConAgra for failing to have a noncompete or nondisclosure agreement with executives in place); Whyte v. Schlage Lock Co., 125 Cal. Rptr. 2d 277, 293 (Cal. Ct. App. 2002) (criticizing an inevitable disclosure argument because "[the parties] did not agree upon a covenant not to compete. We decline to impose one, however restricted in scope, by adopting the inevitable disclosure doctrine.").

cause the law regarding what constitutes good consideration for such a contract has changed in the state where she lives. Three of the employees who go with her only have confidentiality agreements, and three others have no contracts at all. A legal action follows where the contract is found to be unenforceable, *but* the court concludes that the new business would inevitably involve the use of trade-secret customer information and that the management level employee violated her duty of loyalty to the old employer by soliciting the employees to join her. The court enjoins all seven of the former employees from working in the competitor's new business line. The customers abandon both companies and take their work elsewhere. The new employer faces a large damage claim.

Under scenario five, we have the same scenario as above, except the court finds for the departing manager and refuses to issue any injunctive relief. However, when the management level employee was hired, the owner of the business took her under his wing and introduced her to all of his customers. For five years, he paid her to develop and expand the customer base. The business owner hired twenty new employees based on the growth of the business. He is just beginning to turn a good profit and recover some of the costs invested over the last five years. It is at this point that the trusted management employee leaves and takes six employees and most of the customers with her. The new competitor will have none of the start up and investment costs that the old company sank into the business, so it is instantly profitable at little cost and can afford to pay the newly hired executive more because of this difference. The old company is destroyed and sinks into bankruptcy. Employees lose their jobs.

Finally, in scenario six, you represent the employer stung in scenario three. You shift gears to a more aggressive stand and insist that all employees above a certain level sign noncompete agreements. One of your employees in California refuses to sign the noncompete and is terminated. The employee sues for wrongful discharge under California's expansive public-policy exception and wins.[4] Your company is hit with a sizable damage award, and the employee is out of work.

If the parties had a reasonably limited contract that was predictably enforceable, would they have acted differently in each of the above referenced scenarios? Would they have avoided the cost of unpredictability? Couldn't reasonable limitations be established in a contract that protects legitimate business interests such as trade secrets, confidential information, and customer goodwill without unreasonably limiting the employee's mobility? Are there ways to create a disincentive to employer over-reaching that will not result in an "all or nothing" end result? These questions may be rhetorical, but they highlight significant issues.

4. *See, e.g.*, D'Sa v. Playhut, Inc., 102 Cal. Rptr. 2d 495, 499 (Cal. Ct. App. 2000).

For many years courts have struggled to maintain a balance between (a) protecting healthy competition and employee mobility and (b) the need to protect legitimate business interests that may be compromised by the conversion of valuable information and business goodwill invested in the employee. The result is a hodge podge of conflicting and uncoordinated laws, and common law principles that create a nightmare of unpredictability for the practicing attorney looking for tools to use other than contract restrictions.[5] On one side, free markets and open competition are highly valued and even statutorily protected.[6] Employee mobility is recognized as a critical cog in the wheel of commerce. Employees are often the subject of protective laws designed to prevent employers from taking advantage of the greater bargaining leverage generally enjoyed by them.[7]

On the other side, it can be argued that a critical part of our economy is now dependent upon the ability to capture, protect, and sell valuable information and services that are easily compromised by departing employees. Service sector jobs now amount to more than 40% of American jobs.[8] Service jobs are inherently information heavy. Something that sounds as simple as a customer list can now represent a vast pool of knowledge developed at considerable time and expense that includes information about historical purchasing trends, credit history, and analysis of future needs for a company's customers. In one case, this may be a protectable trade secret;[9] in another it will not be.[10] In some cases, the odds of protecting a trade

5. *See* Peter J. Whitmore, *A Statistical Analysis of Noncompetition Clauses in Employment Contracts*, 15 J. CORP. L. 483, 485 (1990) (noting that the tremendous volume and variety of case law makes predictability very difficult for practicing attorneys).

6. *See* Sherman Act, 15 U.S.C. §§ 1–7 (2002).

7. *See, e.g.*, CAL. BUS. & PROF. CODE § 16600 (West 1997).

8. *See* Rachel S. Arnow-Richman, *Bargaining for Loyalty in the Information Age: A Reconsideration of the Role of Substantive Fairness in Enforcing Employee Noncompetes*, 80 OR. L. REV. 1163, 1199 & n.123 (2001) (citing Anthony P. Carnevale & Donna Desrochers, *Training in the Dilbert Economy*, 53 TRAINING & DEV. 32, 32 (1999) and STEPHEN A. HERZENBERG ET AL., NEW RULES FOR A NEW ECONOMY: EMPLOYMENT AND OPPORTUNITY IN POSTINDUSTRIAL AMERICA 2–3 (The Twentieth Century Fund Book 1998) (1998)). Special acknowledgment is due to the above referenced article by Arnow-Richman, which was heavily relied upon as a source of information incorporated here.

9. *See* Miller Paper Co. v. Roberts Paper Co., 901 S.W.2d 593, 600–02 (Tex. App.—Amarillo 1995, writ denied); Centrol, Inc. v. Morrow, 489 N.W.2d 890, 894–95 (S.D. 1992).

10. *See, e.g.*, Central Plastics Co. v. Goodson, 537 P.2d 330, 334–35 (Okla. 1975) (holding that most of the customer list was available anywhere and did not constitute a trade secret).

secret are greatly increased with a contract;[11] in others they are not.[12] In yet others, the failure to use a contract can be fatal.[13]

Geographic barriers are gone. As mobile employees move from state to state, the ability to define what protection will exist, if any, becomes increasingly unpredictable. Modern technology makes older concepts about competition within certain geographical boundaries almost meaningless. Anyone with access to a computer or a cell phone can compete and transmit huge volumes of valuable information with the click of a button from almost anywhere. There is a genuine need for one uniform solution that parties can rely on for predictable results.

Below, a number of contract options are submitted for purposes of discussion and consideration. This is not intended to be a national survey on the subject. A variety of different state's laws will be referred to for purposes of illustration only.

II. The Foundation of Unpredictability

A. *Protectable Interest*

A restraint against competition with no purpose other than to prevent competition is considered a naked restraint of trade and will ordinarily not be enforced.[14] However, there are exceptions where the restrictions at issue are necessary to protect a legitimate business interest. This is sometimes referred to as the "rule of reason" test.[15] The same kind of balancing act occurs in the application of common law causes of action like trade secret misappropriation.[16] However, the balancing test comes into sharp focus most obviously in the context of contractual restrictions. As one commentator stated:

11. *See* Simplified Telesys v. Live Oak Telecom, L.L.C., 68 S.W.3d 688, 693 (Tex. App.—Austin 2000, pet. denied) (stating that the employer must demonstrate "a breach of the confidentiality agreements by misappropriation of a 'trade secret' *or* the use of any *other* information coming within the prohibition contained in the agreements . . . ").

12. *See* T-N-T Motorsports, Inc. v. Hennessey Motorsports, Inc., 965 S.W.2d 18, 22 (Tex. App.—Houston [1st Dist.] 1998, orig. proceeding) (noting that simply designating information as confidential will not suffice).

13. *See* ConAgra, Inc. v. Tyson Foods, Inc., 30 S.W.3d 725, 730–31 (Ark. 2000) (finding that failure to use a confidentiality agreement or noncompete contract was evidence of lack of adequate measures to protect trade secrets); Del Monte Fresh Produce Co. v. Dole Food Co., 148 F. Supp. 2d 1326, 1337 (S.D. Fla. 2001) (rejecting a request to enjoin employee from seeking employment because employer did not enter into a noncompete agreement).

14. *See* Hasty v. Rent-A-Driver, Inc., 671 S.W.2d 471, 473 (Tenn. 1984) (citing All Stainless, Inc. v. Colby, 308 N.E.2d 481, 486 (Mass. 1974)) ("An employer, however, cannot by contract restrain ordinary competition.").

15. *See* Maureen B. Callahan, Comment, *Post-Employment Restraint Agreements: A Reassessment*, 52 U. Chi. L. Rev. 703, 709 (1985).

16. *See id.* at 716.

> This balancing of interests takes place within a developed doctrinal framework that contains specified prerequisites to enforcement. At the threshold, employers must show that they have an underlying interest that the law is willing to recognize. Employers have no right to enforce a noncompete merely for purposes of indenturing an employee to his or her current post, nor any right to prevent competition per se. To avoid unfair effects on employees and competitors, courts require the presence of special interests or circumstances that justify a restriction.[17]

Exceptions have been recognized for reasonable restraints designed:

(1) to protect trade secrets and confidential information of the company;[18]
(2) to protect customer goodwill developed for the company (customer relationships);[19]
(3) to protect overall business goodwill and assets that have been sold (noncompetes used in the sale of a business);[20]
(4) to protect unique and specialized training;[21]
(5) for situations in which the employer has contracted for the services of an individual of unique value because of who they are (e.g., performers, professional athletes);[22] and
(6) for pinnacle employees in charge of an organization.[23]

Employers have also been allowed to use restrictive covenants to protect existing employment relationships and guard against employee raiding. However, this is often considered a different type of agreement or restraint.[24]

Not every state will consider an employer's interest in protecting one or more of the legitimate business interests described above as adequate justification for placing a restraint on an employee's ability to compete.[25] For example, California generally prohibits true noncompete contracts except where the sale of a business or actual

17. Arnow-Richman, *supra* note 8, at 1175.

18. *See* DeSantis v. Wackenhut Corp., 793 S.W.2d 670, 684 (Tex. 1990); TEX. BUS. & COM. CODE ANN. § 15.50 (Vernon 2002) (referencing goodwill as a legitimate interest).

19. *See* § 15.50.

20. *See* Oliver v. Rogers, 976 S.W.2d 792, 797–801 (Tex. App.—Houston [1st Dist.] 1998, pet. denied).

21. *See DeSantis*, 793 S.W.2d at 684.

22. *See* Borg-Warner Protective Servs. Corp. v. Guardsmark, Inc., 946 F. Supp. 495, 501 (E.D. Ky. 1996) (recognizing special character of talent agreements for professional athletes, etc.).

23. *See* COLO. REV. STAT. § 8–2–113(2)(c) (2001) (allowing noncompete contracts for top management personnel, officers, and their professional staff).

24. *See* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ran, 67 F. Supp. 2d 764, 774 (E.D. Mich. 1999); Totino v. Alexander & Assocs., Inc., No. 01-97-01204-CV, 1998 WL 552818, at *8–9 (Tex. App.—Houston [1st Dist.] Aug. 20, 1998, no pet.) (not designated for publication).

25. *See* N.D. CENT. CODE § 9–08–06 (1987).

misappropriation of trade secrets is involved.[26] Colorado will allow a noncompete for protection of trade secrets, to recover expenses for training, and for certain high level executives and their professional staff.[27] Likewise, from state to state there are variations in the nature and degree of the protection afforded to these interests and the circumstances in which they will be enforced.[28]

B. *Common Law Protections*

1. Application of the Inevitable Disclosure Doctrine

Some creative employers are beginning to use contracts that reference, and state as their purpose, the prevention of inevitable disclosure of trade secrets. Disclosure of trade secrets is probably the most universally recognized legitimate business interest warranting a restraint on competition, so using contract language that focuses on this interest is logical. In this type of provision, the contract states that the trade secrets would be inevitably disclosed if the employee went to work for a certain list or category of competing companies and worked in a certain role. The drafter seeks to capitalize on the application of the inevitable disclosure doctrine and contractually stipulate to its application. No case could be located that directly addresses this type of provision. The states are mixed on how the common law concept should be applied.[29]

Standing alone as a common law claim, application of the inevitable disclosure doctrine as part of a misappropriation of trade secrets or confidential information claim is not a very effective solution. In theory, the inevitable disclosure doctrine would be used to provide injunctive relief against a former employee even if the employee did not sign a noncompete agreement or if the employee's noncompete is held unenforceable. Typically, to prove inevitable disclosure, an employer will have to show that: (a) the former employee had access to trade secrets or confidential information, (b) the employee was hired by a competitor who would gain an advantage from use of this information, and (c) the employee's position with the competitor will unavoidably result in the use of this information because the employee will not be able to perform his or her duties for the new employer without using

26. *See, e.g.*, CAL. BUS. & PROF. CODE §§ 16600–16601 (West 1997 & Supp. 2003); Hollingsworth Solderless Terminal Co. v. Turley, 622 F.2d 1324, 1338 (9th Cir. 1980); *see also* N.D. CENT. CODE § 9–08–06 (1987).

27. COLO. REV. STAT. § 8–2–113 (2001).

28. *See* LA. REV. STAT. ANN. § 23:921 (West 1998 & Supp. 2003) (explaining that in special categories, such as the sale of goodwill and franchise relationships, there is a two year limitation); Bail Bonds Unlimited, Inc. v. Chedville, 01-1401 (La. App. 5 Cir. 10/29/02), 831 So. 2d 403, 406, *writ denied*, 2002-2913 (La. 2/7/03), 836 So. 2d 104 (applying the statute only when employee is starting his own business, not when going to work for another).

29. *See* Whyte v. Schlage Lock Co., 125 Cal. Rptr. 2d 277, 291 (Cal. Ct. App. 2002).

the information.[30] However, a number of the more recent decisions have been critical of the inevitable disclosure doctrine on the grounds that it should not be applied where it would act as a backdoor means of achieving a noncompete type restriction without meeting state law requirements normally placed on such a restriction when applied through contract.[31] More importantly for the analysis here, a common law doctrine of this nature does not have the advantage of clear notice to all parties regarding individually defined and negotiated boundaries that a contract restriction can provide. Instead, the parties do not know exactly where a court may draw the lines until the litigation cost is absorbed. Thus, even where the doctrine is helpful as a common law alternative, it does not advance the ball on increasing true predictability.

2. Tortious Interference as an Alternative

A number of recent decisions have shifted the focus of unfair competition claims away from contractual obligations and toward the common law claim of tortious interference. The distinction in the Restatement of Torts between tortious interference with a contract and tortious interference with a prospective business relationship is widely recognized.[32] Interference with an existing contract often does not require the additional element of independent wrongfulness in order to be actionable, whereas tortious interference with a prospective business relationship does.[33] It stands to reason that there is an advantage to the employer in creating contractual obligations that are subject to interference. However, the end result is still often dependent on the enforceability of the underlying contract restriction or the presence of some common law cause of action with more ambiguous boundaries. The result is not a good practical solution to the unpredictability problem.

C. *Consideration*

1. Can a Contract Provision Solve the Consideration Issue?

The answer is "yes" and "no." Yes, recognition of specific consideration is generally helpful for enforcement just as it would be with any

30. *See* PepsiCo, Inc. v. Redmond, 54 F.3d 1262, 1269 (7th Cir. 1995); FMC Corp. v. Varco Int'l, Inc., 677 F.2d 500, 503–05 (5th Cir. 1982); Merck & Co. v. Lyon, 941 F. Supp. 1443, 1460 (M.D.N.C. 1996).

31. *See Whyte*, 125 Cal. Rptr. 2d at 293; Del Monte Fresh Produce Co. v. Dole Food Co., 148 F. Supp. 2d 1326, 1337 (S.D. Fla. 2001) (rejecting the doctrine of inevitable disclosure).

32. *See* Prudential Ins. Co. v. Fin. Review Servs., Inc., 29 S.W.3d 74, 77–78 (Tex. 2000) (stating elements of interference with existing contract); Allied Capital Corp. v. Cravens, 67 S.W.3d 486, 491 (Tex. App.—Corpus Christi 2002, no pet.) (stating elements of interference with prospective business relations).

33. *See* Altrutech, Inc. v. Hooper Holmes, Inc., 6 F. Supp. 2d 1269, 1276–77 (D. Kan. 1998).

contract. No, there is no one uniform way to do it in most circumstances because what constitutes adequate consideration varies too much between states and circumstances. In many states, the company's willingness to employ an individual and/or put him in a position where one or more protectable business interests are implicated will be considered adequate consideration.[34]

In other states, more unique consideration must be provided. This is particularly true for noncompetes that are executed mid-stream.[35] A promotion or change in position will sometimes be enough, as will additional compensation.[36] However, the courts are certainly not consistent on this point,[37] and if the employee is given no real choice, the scenario will still invite arguments about duress or invalidity due to the contract of adhesion doctrine.

In Texas, a unique problem exists because the statute has been interpreted to require more when contracts covered by the statute as a "restriction against competition" are concerned.[38] The Texas statute has been interpreted so as to make the character of the consideration, rather than the quantity of the consideration, controlling.[39] The Texas statute requires that the noncompete agreement be ancillary to an "otherwise enforceable agreement at the time the agreement is made."[40] The ancillary agreement at issue must also meet the following two part test: (1) the consideration provided by the employer in the ancillary agreement "must give rise to the employer's interest in restraining the employee from competing," and (2) the noncompete restraints at issue "must be designed to enforce the employee's consideration or return promise" in the ancillary agreement (the *Light* test).[41] This approach creates a great deal of unpredictability and an "all or nothing" result in many cases.

34. *See* 1 BRIAN M. MALSBERGER, COVENANTS NOT TO COMPETE, A STATE-BY-STATE SURVEY 307–10, 346–47, 412–13, 538–39, 1101–02 (Samuel M. Brock, III & Arnold H. Pedowitz eds., 3d ed. 2002).

35. *See* CRC-Evans Pipeline Int'l, Inc. v. Myers, 927 S.W.2d 259, 264–65 (Tex. App.—Houston [1st Dist.] 1996, no writ).

36. Ashland Oil, Inc. v. Tucker, 768 S.W.2d 595, 601 (Mo. Ct. App. 1989).

37. *See* CRC-Evans Pipeline Int'l, Inc., 927 S.W.2d at 263–65; *Ashland Oil, Inc.*, 768 S.W.2d at 601.

38. *See* Light v. Centel Cellular Co. of Tex., 883 S.W.2d 642, 647–48 (Tex. 1994).

39. *See id.* at 647–48.

40. TEX. BUS. & COM. CODE ANN. § 15.50 (Vernon 2002).

41. The most common example of a contract that meets the *Light* test is the following exchange: (1) the employer makes an enforceable promise to give employee trade secrets, (2) in return, the employee promises not to disclose or engage in unauthorized use of the trade secrets, and (3) the parties agree to a set of post-termination restrictions that restrain the employee from engaging in conduct where she is likely to break her promise not to disclose (*e.g.*, working for a competitor, soliciting customers, etc.). A successful application of this approach through an independent trade secret clause can be seen in the case of *Ireland v. Franklin*, 950 S.W.2d 155, 158 (Tex. App.—San Antonio 1997, no writ) (enforcing the noncompete agreement and noting that the agreement had carefully followed the *Light* blueprint). *See also* Flake v. EGL Eagle Global Logistics, L.P., No. 14-01-01069-CV, 2002 WL 31008136, at *3 (Tex. App.—

D. *Scope of Restraint*

1. Are There any Contractual Boundaries that are Uniformly Enforced?

The scope of the permissible restraint varies greatly from state to state as well. The most uniformly enforced restrictions seem to be those that focus on prohibiting solicitation of customers as opposed to more generalized geographic restraints against competition.[42] However, this is one of the areas where a one-contract-fits-all approach becomes most difficult, if not impossible. Many states take many different approaches to what is a reasonable restriction. In one state, there may be a presumption of enforceability if the restriction is under two years.[43] In another, the geography must be limited in a very specific way or the contract will not be enforced at all.[44] In one state, a customer specific restriction can be used to substitute for a geographic boundary, while in another state it will not.[45] In one state, a general reference to "competing activity" may be sufficient. In another, the failure to define the scope of competing activity with particularity may be fatal. In yet another, only the starting of a new business may be covered while moving to an existing business may not be.[46]

E. *Blue Pencil Rules and Over Broad Restrictions*

1. Can Problems with the Scope of the Restrictions be Overcome Through a Provision Authorizing Judicial Reformation of the Agreement?

A contractual clause allowing for the revision or "blue-penciling" of the contract will rarely be recognized as a method to override the existing contract revision limitations that a state's common law rules of contract construction place on the judge. There are significant variances between states on this issue. As a general rule, they can be broken down into three categories: 1) the delete-the-offending-language-only approach (Indiana, Louisiana); 2) the reforming and redrafting approach (Florida, Ohio, Texas); and 3) the no revisions

Houston [14th Dist.] Sept. 5, 2002, no pet.) (not designated for publication) (stating and applying the *Light* test); Bandit Messenger of Austin, Inc. v. Contreras, No. 03-00-00359-CV, 2000 WL 1587664, at *3 (Tex. App.—Austin Oct. 26, 2000, no pet.) (not designated for publication) ("A promise by the employer to give an employee trade secrets in return for the employee's promise to keep them secret has been found to be one type of non-illusory promise that can support a covenant not to compete.").

42. *See* Arnow-Richman, *supra* note 8, at 1175–80 (surveying cases). *See generally* 1 MALSBERGER, *supra* note 34 (compiling the states' requirements for enforcement of employment agreements).

43. *See* 1 MALSBERGER, *supra* note 34, at 419.

44. 1 *id.* at 565–78.

45. 1 *id.* at 578–79, 777.

46. *See* Bail Bonds Unlimited, Inc. v. Chedville, 01-1401 (La. App. 5 Cir. 10/29/02), 831 So. 2d 403, 406, *writ denied*, 2002-2913 (La. 2/7/03), 836 So. 2d 104.

allowed—all or nothing approach (Georgia, Missouri, Wisconsin, California).[47]

In Texas, the approach is dictated by statute.[48] The enforcing employer loses the right to recover damages if the contract has to be reformed in order to be enforceable, and may even be responsible for the attorney's fees of the opposing party if the opposing party can show that the employer knew the contract was overbroad at the time it was entered into.[49] This is a logical way to create a balance of interests, but it has not been adopted in other states.

Consequently, it is dangerous for an employer to overreach when drafting a noncompete on the theory that it is better to be overbroad than to be too narrow and miss something that needed protection. In reality, it is probably better to be narrow and protect a critical core business interest than it is to be overbroad and have all of the restrictions thrown out together as unenforceable, leaving the core interests unprotected. However, defining the core protectable interest requires predictability. As noted above, beyond trade secrets, it is unclear what a protectable interest will be from one state to the next.[50]

F. *Choice of Law and Venue*

1. Can a Contractual Choice of Law and Venue Avoid the Unpredictability of State Law Variances?

It does not appear that a contractual choice of law and venue fixing clause will cure the unpredictability created by state law variances. Although states vary, the predominant approach to this issue is to use the Restatement of Conflicts analysis.[51] This analysis results in a focus on which state has the materially greater interest (i.e., the most substantial relationship and compelling state public policy interest) in the dispute.[52] As a practical matter, this will often boil down to who won the race to the courthouse as most courts will tend to favor their own state's law in this kind of analysis. Venue fixing provisions can be helpful,[53] but they are not a complete cure. Some states, like Louisiana, now even prohibit them in this kind of contract.[54] In addition,

47. *See* Arnow-Richman, *supra* note 8, at 1179 n.47.

48. TEX. BUS. & COM. CODE ANN. §15.51 (Vernon 2002 & Supp. 2003).

49. *Id.* § 15.51(c).

50. *See supra* Part II.

51. *See* DeSantis v. Wackenhut Corp., 793 S.W.2d 670, 677–78 (Tex. 1990). *See generally* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187 (1971) (explaining what law prevails when no provision is made in the agreement by the parties).

52. *See DeSantis*, 793 S.W.2d at 678.

53. *See* Holeman v. Nat'l Bus. Inst. Inc., 94 S.W.3d 91, 94–95 (Tex. App.—Houston [14th Dist.] 2002, pet. denied) (dismissing declaratory judgment action due to choice of forum clause selecting Georgia).

54. *See* LA. REV. STAT. ANN. § 23:921.A(2) (West Supp. 2003) (indicating that a forum clause or choice of law clause shall be null and void in a noncompete unless

personal jurisdiction and forum non conveniens challenges will often be a significant hurdle.

III. The Eight Most Common Contract Solutions: Advantages & Disadvantages

A. *Nondisclosure/Confidentiality Agreements*

This kind of agreement simply provides that the employee will not disclose or engage in unauthorized use of company trade secrets and confidential information. There is some debate over whether or not the information at issue has to be truly "secret" to be protectable as a trade secret.[55] For this reason, it is advantageous to define trade secrets and confidential information separately, and then provide for the contractual protection of both. It is best to use broad definitions and avoid trying to create comprehensive lists of what is protected. The nondisclosure obligation is usually not limited by time or geography.[56] One approach is to provide that the nondisclosure clause will remain in effect for as long as the employer maintains the information as confidential with a presumption that this period will be at least two years.[57]

Advantages: Nondisclosure agreements are widely enforced.[58] They can give the employer an argument for recovery of attorneys' fees that it would not have in a common law trade secret dispute.[59] Sometimes they can be used in connection with the inevitable disclosure doctrine to prevent an employee from working in a job where disclosure is inevitable.[60]

Disadvantages: The breach of a nondisclosure agreement can be hard to discover and/or prove. Once a violation occurs, the employer is likely to be harmed in a way that cannot be repaired. The proverbial "genie is out of the bottle." It is not a very effective way to protect customer relationships, because much of the information on customers will not qualify for trade secret status. It will not protect the goodwill of a business, and courts have a disturbing tendency to

"ratified by the employee after the occurrence of the incident which is the subject of the civil or administrative action").

55. *See* Miller Paper Co. v. Roberts Paper Co., 901 S.W.2d 593, 602 (Tex. App.—Amarillo 1995, writ denied); 2 Malsberger, *supra* note 34, at 2163–67.

56. *See* Zep Mfg. Co. v. Harthcock, 824 S.W.2d 654, 663 (Tex. App.—Dallas 1992, no writ); 2 Malsberger, *supra* note 34, at 2167.

57. *But see* Fla. Stat. Ann. § 542.335(1)(d) (West 2002 & Supp. 2003) (presuming unreasonable "any restraint more than [two] years in duration").

58. *See, e.g.*, Gordon v. Landau, 321 P.2d 456, 458–59 (Cal. 1958) (showing that California's general prohibition on noncompetes was not offended by nondisclosure agreement).

59. *See* Tex. Civ. Prac. & Rem. Code Ann. § 38.001 (Vernon 1997 & Supp. 2003).

60. *See, e.g.*, PepsiCo, Inc. v. Redmond, 54 F.3d 1262, 1271–72 (7th Cir. 1995).

use injunctive relief in a limited way that tends to give an employee "one free bite" at the trade secret apple.[61]

B. *No-Raiding of Employees (Anti-Piracy) Agreement*

This is a promise by the former employee not to hire away or solicit employees to leave the company for some period of time.

Advantages: In some states, it may not be construed as a noncompete agreement and therefore, may be treated less critically by the courts.[62]

Disadvantages: It can often be difficult to prove, because the former employee can usually claim that "he called me looking for a job; I did not solicit him." This restriction does not protect trade secrets or customer goodwill very effectively. An employee can leave and harm protectable interests without engaging in employee raiding.

C. *"Non-Solicitation of Customers" Agreement*

The employee promises not to solicit company customers for a specific time. The scope of customers covered will usually be limited in some way, unless the employee is at a high level within the company. In many states, the company cannot prohibit solicitation of *all* company customers because the employee will not have had contact with all of the customers (i.e., no goodwill to protect) and will not have handled confidential information about all of the customers.[63]

Advantages: It is narrowly tailored to protect existing customer relationships. Consequently, it is one of the most widely enforced restrictive covenants.[64] Some states will not view "non-solicitation of customers" agreements as true noncompetes.[65]

Disadvantages: A breach can be difficult to prove for the same reasons a breach of a no-raiding clause can be (discussed above). It is not entirely clear that a customer specific restraint can be used to substitute for a restraint with a geographic limitation in some states. In most states, this substitution is allowed.[66] It addresses customer goodwill, but not necessarily trade secret issues.

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61. *See* Eden Hannon & Co. v. Sumitomo Trust & Banking Co., 914 F.2d 556, 561–62 (4th Cir. 1990) (criticizing the reluctance of courts to issue injunctive relief before misappropriation has occurred because it means the employee "tends to get 'one free bite' at the trade secret").

62. *See* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ran, 67 F. Supp. 2d 764, 774 (E.D. Mich. 1999); Totino v. Alexander & Assocs., Inc., No. 01-97-01204-CV, 1998 WL 552818, at *8–9 (Tex. App.—Houston [1st Dist.] Aug. 20, 1998, no pet.) (not designated for publication).

63. *See, e.g.*, Peat Marwick Main & Co. v. Haass, 818 S.W.2d 381, 385–88 (Tex. 1991); *see* 1 MALSBERGER, *supra* note 34, at 565–66, 710, 774–75.

64. *See* 1 MALSBERGER, *supra* note 34, at 290, 316, 350, 375, 710, 777.

65. *See* Sevier Ins. Agency, Inc. v. Willis Corroon Corp. of Birmingham, 711 So. 2d 995, 998–99 (Ala. 1998); *Haass*, 818 S.W.2d at 385.

66. *See* 1 MALSBERGER, *supra* note 34, at 290, 316, 350, 375, 710, 777.

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D. *True Noncompete Agreement*

The employee promises not to do certain kinds of work for a competing company for a specific period of time within a certain geography.

Advantages: A breach is often easy to spot and prove. Either the ex-employee is working for a competitor in a certain geography or not.

Disadvantages: Some states completely prohibit them,[67] and almost all states view them critically.[68] Defining the boundaries can be very difficult and will tend to require individually tailored contracts by person or by job in order to be so narrow that it can survive in states where no blue pencil reformation by the court is allowed.

E. *Noncompetes Tied to Stock or Stock Options/Using Stock as Consideration*

It is increasingly common to see noncompete provisions tied to stock options or stock grants. The stock is used as the consideration. There are a number of uncertainties with this approach. There are few published opinions on it.[69] The employer may have difficulty convincing a court that injunctive relief against competition is the proper remedy, since monetary damages based on the value of the stock would be quantifiable. In addition, if stock options are forfeited for a violation of the noncompete, this forfeiture may be viewed as a satisfactory remedy.

F. *Mandatory Advance Notice and Notice Period*

This is a promise by the employee that he or she will give the company a specific amount of notice before leaving and will advise the company if he or she is going to work for a competitor.[70]

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67. *See* 1 *id.* at 231.

68. *See* 1 *id.* at 242–43, 286, 407–12, 534–38; 2 MALSBERGER, *supra* note 34, at 2167–75.

69. *See* IBM v. Bajorek, 191 F.3d 1033, 1040–41 (9th Cir. 1999) (holding that this kind of agreement was different from a true noncompete because it only provided for forfeiture of stock and was, therefore, not a violation of California's state law against noncompetes); Olander v. Compass Bank, 172 F. Supp. 2d 846, 855 (S.D. Tex. 2001), *aff'd*, 2002 WL 1396903 (5th Cir. 2002) (not designated for publication) (deciding there was no evidence that employer's grant of stock options to at-will employee gave rise to its interest in restricting employee from competing; however, the court added that it was not ruling "that a stock option agreement can never give rise to an interest in restraining competition"); Totino v. Alexander & Assocs., Inc., No. 01-97-01204-CV, 1998 WL 552818, at *7 (Tex. App.—Houston [1st Dist.] Aug. 20, 1998, no pet.) (not designated for publication) (holding stock option award was an ancillary agreement supporting noncompete).

70. *See* Hansson v. Time Warner Entm't Advance, No. 03-01-00578-CV, 2002 WL 437297, at *2 (Tex. App.—Austin Mar. 21, 2002, pet. filed) (not designated for publication) (holding provision requiring that Hansson give the company 30 days notice

Advantages: This notice is not likely to be considered with the same hostility as a noncompete agreement.[71] Advance notice of a competing job gives the old employer time to pursue injunctive relief before irreparable harm is done. As long as the employee remains employed and on the payroll of the company during the notice period, he or she will have a duty of loyalty to the employer not to engage in competition or other activities that harm the employer.

Disadvantages: The employee is either relieved of active duties and asked to sit out the remainder of the notice period, or remains an employee working alongside others. In both scenarios, the employee would remain on the payroll of the company in order to trigger the continuing duty of loyalty. In the first scenario, the employee is paid to do nothing. In the second scenario, the employee is in the workplace and more likely to cause harm to employee morale, etc.

G. *Post-Termination Consulting Period/Pay for No-Play Approach*

Employee promises that upon termination of employment, he or she will remain a consultant for a set period of time during which he or she will continue to receive some pay from the employer and during which time the employee (now consultant) will refrain from competing. This approach is sometimes referred to as a "garden leave" agreement based on an English contract law concept.[72]

Advantages: This approach has equitable appeal to courts because the employee is continuing to receive compensation. Because the individual is still acting for the company as a consultant, the contract is less likely to be viewed as a post-termination of employment restraint on competition. Instead, it is more like an extension of the ordinary duty of loyalty requirement for an employee.

Disadvantages: A competitor can simply buy out the value of the consulting agreement to the employee by offering him or her enough money to offset the consulting payments. If the employee refuses to continue to serve in the role of a consultant and refuses the payments offered by the company, it is unclear whether or not the company could enforce any restrictions against competition by the former employee.

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upon receiving an offer from a competitor was not a post-termination noncompete restriction covered by TEX. BUS. & COM. CODE ANN. § 15.50 (Vernon 2002)).

71. *Id.* at *6–7.

72. *See* John Fellas, *Garden Leave: A New Weapon Against a Departing Employee*, N.Y.L.J., May 29, 1997, at 1, 4; W. Gary Fowler, *Drafting Effective Noncompetition Covenants: The Incredible Darkness of* Light v. Centel Cellular, DALLAS B. ASS'N LAB. & EMP. SEC., Aug. 19, 2002, at I-12; Peter E. Calamari, *Protection of Confidential Business Information*, PRACTISING L. INST., Feb.-Apr. 2001, at 35, 47.

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H. *Liquidated Damages/Forfeiture Clauses*

Employee promises to pay some fixed liquidated damage if he or she goes to work for a competitor or solicits a customer away. Alternatively, the employee agrees to forfeit certain monies or benefits that he/she would otherwise be entitled to if he/she violates the noncompete or non-raiding restrictions.

Advantages: There is an argument that this is not a true noncompete because it does not prohibit competition; it simply puts a price on it that the employee must pay in order to compete.[73] If it is not considered a noncompete agreement in restraint of trade, it is much more likely to be enforced.

Disadvantages: Many courts do not buy the argument that such a clause is not a noncompete.[74] For example, the Texas Supreme Court has specifically rejected this argument.[75] In addition, this approach invites the competitor to buy the employee away by offering him or her enough to offset the liquidated damage or forfeiture.

IV. Conclusion

As the foregoing contract options reflect, no one contract solution emerges as a strong, predictable, and reliable solution. As the beginning of this discussion illustrates, there is a steep price for the unpredictability this creates. A uniform set of guidelines for contract construction and application in this subject area is badly needed. Some form of uniform covenants not to compete act would be of significant help. A balanced approach like that originally contemplated by the Texas statute that allows for blue-penciling but creates an incentive to draft such agreements narrowly by shifting attorney's fees would seem to be a logical approach. This would help curb employer over-reaching and avoid "all or nothing" results.[76] Most importantly, some uniform recognition of what is a protectable interest would relieve much of the present instability.

Attacking the creation of a contract with contract of adhesion doctrine or statutes prohibiting noncompete contracts all together is not helpful. It drives litigants towards common law options that are even more ambiguous in their application and less predictable for the parties. Parties need predictability before litigation begins to help guide their decision making. Guesswork that results from unpredictability often results in a heavy price paid by those who guess wrong. On the other side, constantly erring on the side of caution also causes unnec-

73. *See IBM*, 191 F.3d at 1040–41 (presenting an example of ways that courts are interpreting types of noncompetes).

74. *See, e.g.*, Junkin v. Northeast Ark. Internal Med. Clinic, P.A., 42 S.W.3d 432, 438 (Ark. 2001).

75. Peat Marwick Main & Co. v. Haass, 818 S.W.2d 381, 385 (Tex. 1991).

76. However, the *Light* test used in Texas law would not be a useful model to follow.

essary harm, as well. Contract law is best suited to address the issues raised with employee mobility because contracts can be customized to the particular business or position at issue.

However, until a uniform set of guidelines is adopted, contracts will remain an unpredictable device. This is an area of law that is often driven by the facts of particular cases. The result is a results-oriented reasoning by courts that creates a challenge for practitioners everywhere. Many years ago, one court looking at this subject said:

> This is not one of those questions on which the legal researcher cannot find enough to quench his thirst. To the contrary, there is so much authority it drowns him. It is a sea—vast and vacillating, overlapping and bewildering. One can fish out of it any kind of strange support for anything, if he lives so long.[77]

More than fifty years later, the sea is (in an understatement) *bigger.*

77. Arthur Murray Dance Studios of Cleveland, Inc. v. Witter, 105 N.E.2d 685, 687 (Ohio Ct. Com. Pl. 1952).