Business Better (Season 1, Episode 26): An Overview of Employment Restrictive Covenants

Speakers: David Fryman, Juliana van Hoeven, Elliot Griffin

John Wright:

Welcome to Business Better, a podcast designed to help businesses navigate the new normal. I'm your host, John Wright. After serving nearly 15 years as senior vice president and general counsel at Triumph Group Incorporated, a global aerospace component supplier, I'm now a member of the securities and M&A groups at Ballard Spahr, a national law firm with clients across industries and across the country.

John Wright:

Today's episode features a discussion of employment restrictive covenants, including the circumstances that make the use of restrictive covenants advisable or not, what's required to make them enforceable and how that can vary from state to state, and the impact of the COVID-19 pandemic on enforcement. Leading the discussion is David Fryman, a partner in Ballard's Philadelphia office, who represents employers in all types of labor and employment matters. Joining David are Juli van Hoeven and Elliot Griffin, both of whom are associates in the Philadelphia office, with experience in a broad range of labor and employment matters. With that, we'll turn the episode over to David, Juli, and Elliot.

David Fryman:

Hello everyone, I'm David Fryman and I'm joined by my colleagues Juli van Hoeven and Elliot Griffin, for an update on employment restrictive covenants.

David Fryman:

Before we get to the latest and greatest, let's do a quick level set refresher. Juli, what are some of the key considerations for employers who may be deciding whether to adopt restrictive covenants?

Juli van Hoeven:

Sure David, and hello everyone. Restrictive covenants can offer employers lots of benefits. For example, they can protect a company's confidential information, or they could provide assurance that key employees will not take clients or customers or other employees with them, if and when they decide to leave the employer's company.

Juli van Hoeven:

But, that doesn't mean that every employer should automatically put restrictive covenants into place, and they may not be a good fit for every employee on the payroll. Considerations can include applicable state laws, so depending on which state laws apply, restrictive covenants of the type that an employer is interested in might not be enforceable at all. Or, they might not be enforceable to the degree that the employer would find sufficient to protect their interests. I know we're planning to get into more about state laws later in the podcast. But, the laws of the state where an employer sits and where an employee is located are often going to inform the analysis on whether restrictive covenants make sense for a particular employer.

Juli van Hoeven:

Another consideration to factor in could be your industry. There are state laws that are industry specific, and they limit how employers can restrict their employees. Two industries that come to mind where restrictive covenants may not be enforceable are in the legal industry, and also for medical professionals. Another example is in Massachusetts, where non-compete

restrictions aren't enforceable against employees who are non-exempt under the FLSA, or the Fair Labor Standards Act. Or, they're also not enforceable against employees who were terminated without cause or laid off.

Juli van Hoeven:

Another consideration might be whether and what kind of company trade secrets exist, that an employer may want to protect. Not every company has information of a kind that will benefit from a restrictive covenant. And, we actually saw this recently in the context of an employer who offers rehabilitation and therapy to adults who live in state sponsored facilities. Their patient lists were publicly available, and so in that case it didn't make sense to use confidentiality clauses to protect that information.

Juli van Hoeven:

An employer might also want to think about employee specific considerations. If a company does have trade secrets that would benefit from these protections, the next question might be whether a particular employee is going to be privy to that employer's confidential information. Employers should consider really targeting only those employees who have access to the information that a company is trying to protect. They might also want to think about whether an employee's training or knowledge of the business is going to be sufficiently complex and unique, that a court will find it reasonable to restrain that person's ability to perform their job.

Juli van Hoeven:

At the end of the day, restrictive covenants are a restraint on an employee's ability to go out and seek new employment, so employers really have to ask themselves whether an employee has the kind of specialty that's going to impact the employer's business, or if that person is engaged in more ministerial tasks that really should be subject to restraint.

Juli van Hoeven:

I know that's a lot to kick us off. David, do you have anything to add?

David Fryman:

Not much, Juli. The only thing I would note is that, in my experience, some employers tend to take for granted the argument that this individual's employment with a competitor poses a substantial risk because of the confidential information this former employee is in a position to use or disclose. Too often, when pressed in litigation, employers are forced to concede, for example, that supposedly confidential pricing in is published publicly, or that the employer's customers share price quotes with the employer's competitors. Or, for example, that confidential customer information actually can be found on the employer's website. I just put that out that as a reminder, particularly in this digital age, that employers much continually monitor the protection of their confidential information.

David Fryman:

Elliot, say an employer has worked through the consideration Juli's outlined and decided to go forward with preparing restrictive covenants. What are some key consideration when it comes to drafting these agreements?

Elliot Griffin:

Thanks, David. Above all, you want to make sure your restrictive covenants are reasonable. What reasonable means will really vary, depending on a number of factors. You also want to consider what type of restrictive covenant you're considering, and Juli laid this out when she spoke. But, a provision to protect confidential information can be ongoing in duration, but if you're thinking about a non-compete or a non-solicit, if you're looking to restrict that employee from taking their coworkers with them, or calling all your clients the next day, those types of agreements need to be a bit more narrowly tailored to be enforceable.

Elliot Griffin:

We talk about narrowly tailored, some of those factors will include geographic scope. If you are, for example, based in Philadelphia and maybe your clients are generally in New Jersey or Maryland, having a non-compete that prohibits a departing employee from working in a job that's in Washington state, where most of their clients are on that side of the Mississippi, might be a bit over-broad.

Elliot Griffin:

You also want to think about your duration, as well. Do you need something that prohibits the employee from working for a competitor for two years after they leave your business? Or, is just one year a bit more reasonable? And, how you defined a competitive industry can be broad and cover the full range of what the employer does, or it can be a bit more narrowly tailored, and focused on restraining an employee in engaging in just a few employment activities that were very unique to their employment. But again, what is reasonable might vary by industry. You can imagine that a company that does cutting edge tech development, and maybe is launching a new product every few months, an employee's knowledge may only be competitive for a short period of time. And maybe there, you're thinking of a non-compete that is about six months in duration. But, if a company's secret sauce so to speak never changes, and maybe this was a high ranking employee who really had their hands in multiple aspects of the business, then a longer duration might be reasonable and much more realistic for your business.

Elliot Griffin:

Once you've gone through all that, to figure out how to really narrowly tailor this agreement, you want to make sure that you've drafted an agreement that is supported by sufficient consideration to be enforceable. And again, this will vary by that so it's important to know your jurisdiction. In some areas, if you're requiring a non-compete be signed at the beginning of an employment, maybe just that offer of at-will employment will be adequate consideration for a non-compete. But in some jurisdictions, additional consideration is required if the non-compete is entered into after the start of the employment relationship. So maybe, in that instance, it needs to be tied to a significant promotion or a bonus, if you're introducing it mid-stream. It might not be the case that just allowing the employee to continue working and hanging around might not necessarily be enough.

Elliot Griffin:

Again, some jurisdictions have very specific requirements for the type of consideration. For Texas for example, post hire restrictive covenants entered into during the existing employer-employee relationship can be supported by consideration that looks a little bit different. It might just be the employer's agreement to provide that employee with confidential information, or highly specialized training, both of which are designed to further the specific business interests that are being protected by the not-compete.

David Fryman:

Thanks, Elliot. Now, both of you have stressed the importance of state laws governing restrictive covenants. Juli, can you tell us a little bit about how to determine what state law is going to apply to these agreements?

Juli van Hoeven:

Yeah, of course. Sometimes the answer is simple, such as when a state's law requires that its own laws are going to apply. In California for example, contracts entered into or modified on or after Jan 1, 2017 cannot contain choice of law provisions that apply another state's law as a condition of employment, where the individual is an employee who is primarily residing in California. In that situation, only California law is going to apply. Another instance that will be straightforward is one where the employer and the employee both work in the same state, and then that state's law is going to apply.

Juli van Hoeven:

But of course, as we know, such scenarios are growing increasingly less common as employers have many different offices and employees relocate all across the country. Particularly right now with COVID-19, so many employees are working outside of the office due to pandemic related restrictions. If the state's law that an employee has relocated to is more friendly to the employees than the state's law where the brick-and-mortar office sits, that could very well impact the choice of law analysis.

Juli van Hoeven:

To address these kinds of situations, employment agreements will often contain a choice of law provision that provides which state's law will govern. In those instances, courts typically uphold the party's choice of law, but it's also possible for one of the party's to challenge the choice of law provision. And then, courts will engage in a choice of law analysis and they may opt to disregard the choice of law provision in favor of another state's law, typically their own. This can happen if there is another state that has a more significant relationship to the parties, or if for some reason one state has a materially greater interest in enforcing the agreement than the other state does. Or also, if application of the other state's law would be contrary to the fundamental policy of the law of the state in which the court is in.

Juli van Hoeven:

Really, what all of this boils down to is that multi-state employers should be familiar with the law of the state in which they are based, and also the laws of the state in which any of their employees are working. And finally, I just want to add that there's also going to be a distinction the choice of law, which is the law that the court is going to apply and the choice of venue, which is the physical location from which the parties agree to litigate any disputes. Some employment agreements contain choice of venue clauses, where the parties agree that the action will be brought in a specific court. Practically, providing for a choice of venue in advance can reduce uncertainty, and can provide the parties with the convenience of litigating in a known forum. But, that doesn't necessarily tell us which state's law is going to apply, just where the parties will physically sit.

David Fryman:

Thanks, Juli. We all know that some state's laws on restrictive covenants are more complex than others.

David Fryman:

Elliot, are there any state laws that have undergone recent changes, or stand out in your mind as particularly unique?

Elliot Griffin:

Sure. Every state certainly has its own quirks, in this context. And, in 2018 Massachusetts really stood out and changed the non-compete game a bit. There, they introduced a Garden Leave requirement. The Garden Leave requirement really dictates that, when a non-compete agreement is entered into, it must be supported by this Garden Leave clause, or other mutually agreed upon consideration. But, for a Garden Leave clause essentially means that the employer is really on the hook after the employee leaves, if they're covered by a non-compete agreement, for a certain period of time to pay a pro-rata share of that employee's wages. If the non-compete agreement is for six months, for six months after that employee leaves, they're on the hook to pay a portion of their wages. As Juli indicated earlier, Massachusetts did not just stop there with the introduction of the Garden Leave clause, they also prohibit the use of non-compete agreements with non-exempt employees, or for employees who have been terminated without cause or laid off.

Elliot Griffin:

Most recently, DC also got involved in this game. Recently, DC passed a ban on most non-compete agreements for employees who work in DC. Another part of this legislation that hasn't gotten as much attention is that it also bans pretty standard policies that prohibit an employee from holding a second job while they're employed. The first thing that comes to mind when we're in this remote work state of the world, is who really counts as an employer or employee in the District of Columbia. An employer is pretty broadly defined here, it includes any businesses operating in the District, and employee is defined as an

individual who performs work in the District on behalf of an employer. So based on the text alone, it's not really clear that it requires a physical presence in DC, or how remote work might play into this.

Elliot Griffin:

Of course, California is, as we've discussed a lot today, really stands out. In California, largely bans employee non-compete agreements. They're, for the most part, void and unenforceable there. There are some caveats that arise in the context of a merger or the sale of a business. There, the state really recognizes that, if you go through the process to buy a business, that that seller shouldn't be allowed to set up shop across the street. In addition, California employers can still use other means to protect trade secrets, like the use of confidentiality agreements or non-disclosure agreements.

Elliot Griffin:

California gets a lot of attention, but the reality is other jurisdictions also have non-compete laws that make non-compete agreements largely unenforceable, or only enforced in pretty limited situations. Some of those states I'll call out, like Colorado, there you're pretty limited to the instances where you can use a non-compete agreement. They're going to be largely be limited to executive employees or members of professional staff. North Dakota, you see restrictions very similar to California there. And Oregon has a list of criteria that you must meet in order to have a valid non-compete agreement, and one of those relates to the employee's income. For you to restrict someone with a non-compete, they must have an annual income that exceeds the median family income for a family of four. So, definitely want to make sure you've got an understanding of your state law there.

David Fryman:

No analysis of employment law at this moment in time is going to be complete without touching on COVID. Are we seeing any impact from the pandemic on restrictive covenants, Juli?

Juli van Hoeven:

Yeah. Unfortunately, we know there have been increased layoffs since the pandemic began. We are also seeing an uptick in lawsuits relating to employment agreements, as employers go to court to try and enforce the restrictive covenants for those employees. However, what's been interesting is that, as a general matter, courts have been less tolerant of employers arguments that they're going to be irreparably harmed if their restrictive covenants are not enforced. Courts are pointing to the fact that the nation is facing such high unemployment rates, and that's an indication that employees are less likely to find alternative employment that could be harmful to their former employer.

Juli van Hoeven:

Employers are also concerned about the likelihood of enforcing non-competes on professionals in the medical field, as the pandemic may affect some court's willingness to enjoin healthcare providers at a time when patients are seeking their services more than ever.

Juli van Hoeven:

And finally, Elizabeth Warren called on the Federal Trade Commission last month to take emergency action to limit employers enforcement of non-competes during the pandemic, when some employees are already facing such a tough job market. The agency said it's reviewing materials related to the possible rulemaking, but it seems unlikely that the FTC will take any drastic steps soon.

David Fryman:

On that point, picking up on that, there's been a lot of chatter about changes to the employment law landscape at the Federal level, with the change in Administrations. Elliot, do you think we're likely to see any Federal regulation on restrictive covenants as a result of our new President's agenda?

Elliot Griffin:

It's certainly possible. It doesn't seem likely, in the immediate future. The Biden Administration has a really packed labor agenda, they seem very focused on OSHA guidelines and protecting workers who still have to report in-person to work, from contracting COVID-19. There are some regulation changes that we've seen from the Department of Labor, and of course right out the gate, shortly after inauguration, there were changes at the National Labor Relation Board. It's certainly been a busy year already for the new Administration, and I'm not sure particularly, when it comes to regulation of restrictive covenants, how this ranks on the priority list.

Elliot Griffin:

This has largely been introduced into the dialogue because of comments that then Vice President made during the Obama Administration. In 2016, the Treasury Department reported that non-compete clauses in contracts reduced wages and wage growth over time, and the Vice President made comments around that announcement. I think that's why some employers might be a bit concerned that this is going to be a priority for him.

Elliot Griffin:

But, while we're focusing on the White House, we shouldn't lose sight of state legislatures. As we walked through earlier, it's really states that have been active in this area, and some states where we don't see a lot of employment regulations coming out of. Employers should definitely look to see what's happening in their states, and the states where their employees might be working from, to see what's next when it comes to restricting the use of restrictive covenants.

David Fryman:

Elliot, Juli, thank you for the update and insights, and thanks to all of you for listening. If you haven't yet done so, please subscribe to the Ballard Spahr Labor and Employment Group's blog, HR Law Watch, for all of the latest developments in the world of employment law.

John Wright:

Thanks again, to David Fryman, Juli van Hoeven and Elliot Griffin. Make sure to visit our website, www.ballardspahr.com, where you can find the latest news and guidance from our attorneys. Subscribe to the show in Apple Podcasts, Google Play, Spotify, or your favorite podcast platform. If you have any questions or suggestions for the show, please email podcast@ballardspahr.com. Stay tuned for a new episode coming soon. Thank you for listening.