

Employers Beware—Is Your Business Setting A Non-Compete Double-Standard?

John P. Barry & Mark Saloman, Proskauer Rose LLP

As employers scramble to adapt to the current financial downturn and make tough decisions to reduce the size and scope of their workforce, it is no surprise that some companies are relaxing the enforcement of their non-compete clauses against departing employees. While a manager may consider this an "act of kindness" in today's economic climate, what are the implications for employers whose remaining workers wish to jump ship to a competitor but are bound by post-employment restraints? This article explains the problems that can arise when companies adopt a double-standard for enforcement (or non-enforcement) of non-competition agreements and provides guidance for managers.

The Delicate Balance: Protecting an Employer's "Legitimate Business Interest" vs. Restraining an Employee's Ability to Work.

Without the important safeguards provided by restrictive covenants, it would be near impossible for most employers to share confidential and proprietary information, formulae, research, and trade secrets with their own employees. Enforceable restrictive covenants provide critical protection of an employer's legitimate business interests by reasonably limiting a former employee's ability to, among other things, exploit a former employer's trade secrets or confidential information, solicit former clients and co-workers, and otherwise unfairly compete with a former employer. Because the employee also has a competing interest in being able to work elsewhere, courts analyze applications to enforce post-employment restraints on a case-by-case basis and often narrowly construe—and in some instances re-write—the temporal duration, geographic area, and overall scope of the restraints at issue.

Enforcing Post-Employment Restraints After a Reduction-In-Force.

How might a decision not to enforce a restrictive covenant against an employee who has been subjected to a layoff or downsizing impact an employer's subsequent attempt to, for example, enforce that same covenant against an employee who leaves for work with a direct competitor? The answer is that an employer must take care to make effective decisions that will serve the organization's immediate needs without setting a precedent that could be used against it later. As workforces contract and former employees begin the unenviable task of seeking new employment, an employer's decision to enforce—or not to enforce—its restrictive covenants today may have repercussions in future proceedings.

A number of states—including New York—generally refuse to enforce restrictive covenants against employees who are involuntarily terminated from their jobs. Nonetheless, an employer's past practices play a part in a court's review of a new

application to enforce a restrictive covenant. So, employers must recognize that a Court may conclude that the balance of fairness tips in favor of the former employee if an employer's past behavior undermines the purported confidentiality of its internal information, belies the unique or important role played by employees similar to the one sought to be restrained, or otherwise runs contrary to what the company will later claim is a business interest worthy of the protection of a post-separation restrictive covenant.

These issues came to the fore in *Estee Lauder Companies, Inc. v. Batra*,¹ when Estee Lauder sought to enforce non-compete and non-disclosure agreements against a high-level executive who had resigned for a job with a direct competitor. Batra's restrictive covenant—the same one Estee Lauder required of all new executives—prohibited Batra for 12 months from the date of his termination, regardless of reason, from, among other things, working for any business on behalf of any competitor where he could benefit the competitor or harm Estee Lauder by using or disclosing confidential information.

On its face, the terms of Estee Lauder's restrictive covenant were reasonable because, as the court noted, some of the trade secrets known to Batra could be expected to hold their value for up to three years. Batra, however, successfully challenged Estee Lauder's attempt to completely enforce its agreement because he demonstrated that the company rarely sought a restraint for the entire one-year duration of its own agreement. On the contrary, the restrictive covenants of other former Estee Lauder executives—at the same level as Batra who possessed the same confidential company information—routinely negotiated much shorter post-separation restraints.

Based upon the company's past practice of reducing its own restrictive covenants with other departing executives, the U.S. District Court for the Southern District of New York held that Estee Lauder's "general behavior surrounding the enforcement of restrictive covenants" suggests that a one-year restraint "is generally unnecessary."² Though most of the restrictive covenant was left intact, it was shortened to five months to conform to what was necessary to protect the company's interests.

Other states place less weight on an employer's past practices and more importance on the employer's discretion to determine what is best for its own business. One New Jersey court, for example, enforced the restrictive covenant of an employer which had historically declined to seek enforcement of the same agreement in similar situations. In *Laidlaw, Inc. v. Student Transportation of America, Inc.*,³ a group of executives resigned from Laidlaw to form their own competing transportation company. Laidlaw sought to enforce the terms of its former employees' restrictive covenants, which barred them from post-separation competition of any kind for five years. The former employees challenged the enforcement application because Laidlaw failed to consistently enforce similar non-compete agreements with other former employees.

In rejecting that argument, the district court recognized that "Plaintiffs may nor may not seek to enforce other covenants, but the primary inquiry is whether enforcement of the covenant in this case is reasonable."⁴ Any other conclusion, according to the

court, would require every employer to enforce its restrictive covenants against every departing employee, without consideration of expense, need, or the particular circumstances of each individual situation. Such a blanket requirement would be unfair to employers, as well as to former employees who do not blatantly violate the terms of their post-employment agreements.

The genesis of *Laidlaw's* holding can be found in *Minnesota Mining and Manufacturing Co. v. Kirkevold*,⁵ which also excused an employer from seeking enforcement of its restrictive covenants against all similarly situated employees. "For the court to hold otherwise would effectively place employers in the precarious position of being compelled to enforce all such restrictive covenants with respect to all its former employees, which might encourage attempts to restrain trade, and which might undermine labor relations."⁶

Can an Employer's Inconsistent Enforcement Lead to Waiver?

Employers who selectively enforce the restrictive covenants of their former employees should nonetheless be cautious. Under certain circumstances, lax enforcement may cause employers to waive, or forfeit, their subsequent claim to protect their business interests.

In *Surgidev Corporation v. Eye Technology, Inc.*,⁷ for example, four officers of a medical devices company were sued by their former employer in an attempt to enforce covenants which prohibited their unfair competition and misappropriation of trade secrets. On the surface, the facts of the case line up squarely in the employer's favor: Surgidev's restrictive covenants were facially valid. Moreover, one former employee (took steps to form a competing company while still employed by Surgidev) and even pledged a \$500,000 treasury bill owned by Surgidev as collateral for a loan he used for his start up competing company. The termination of this employee after his misconduct came to light sparked a mass exodus of key Surgidev employees who resigned to join the new competing venture.

The District Court nonetheless rejected Surgidev's attempt to enjoin these former employees because it had failed to even attempt to enforce the restrictive covenants of no less than 28 former employees, including high-ranking executives, who had left Surgidev over the years for positions with competitors. "Under the circumstances," the court found, "it would be inequitable to permit plaintiff to now rely on a non-compete agreement which it has so blithely ignored in the past."⁸

The defense of waiver is, however, the exception and not the rule because, as one Court said, a former employee must demonstrate that the former employer's prior failures to enforce its restrictive covenants amount to a "complete disregard for those provisions."⁹ Indeed, it has been held that, even where a former employer repeatedly and knowingly referred customers to the former employee, after he impermissibly founded his own firm, this did not amount to a knowing waiver of the terms of the parties' non-compete agreement.¹⁰

Practical Tips for Proactive Employers

Employers may temper the inherent risks of inconsistent enforcement of restrictive covenants and enhance their ability to protect their future interests with a few simple precautions. As an important first step, employers should review and update their post-employment restrictive covenants to make sure they accurately reflect the needs of the business without being impermissibly overbroad. Employees should also consider whether all employees or only higher-level executives should be required to execute such agreements. Limiting the application of restrictive covenants to only those employees who have access to genuine trade secrets or real potential to harm the company through unfair competition decreases the chances of inconsistent enforcement (and waiver) while increasing the likelihood of successful enforcement. Employers can also consider creating contemporaneous documentation (ideally, a "settlement agreement" with the departing employee) summarizing their well-founded rationale behind any choice not to pursue enforcement in certain circumstances. This document should reflect the company's position that its decision not be interpreted as a waiver of any future right to enforce the restrictive covenant against other former employees.

Maximum flexibility is, of course, critical to contemporary business and employers must retain the ability to make sound decisions based upon each departing employee's unique situation. Courts do not require employers to blindly enforce restrictive covenants in every situation without regard for business need, though inconsistent past enforcement may form the basis of an attack on your company's ability to enforce its restrictive covenants in the future.

John P. Barry is a partner in the Labor and Employment Law Department and co-head of the Non-Compete and Trade Secret practice group at Proskauer Rose LLP. Mark Saloman is a senior associate in Proskauer's Labor and Employment Law Department and member of the Non-Compete and Trade Secret practice group. Based in Newark, Mr. Barry and Mr. Saloman are experienced in representing management in a wide range of employment and labor law matters in both New Jersey and New York. They litigate and counsel clients concerning employee movement between competitors, with emphasis on the meaning, enforceability and drafting of various types of restrictive covenants, such as non-competition, non-solicitation and confidentiality provisions. Jonathan S. Hershberg, a summer associate in the firm, contributed to this article.

¹ 430 F. Supp. 2d 158 (S.D.N.Y. 2006).

² *Id.* at 182.

³ 20 F. Supp. 2d 727 (D.N.J. 1998)

⁴ *Id.* at 751 (emphasis in the original).

⁵ 87 F.R.D. 324 (D. Minn. 1980).

⁶ *Id.* at 336.

⁷ 648 F. Supp. 661 (D. Minn. 1986).

⁸ *Id.* at 698.

⁹ *Kempner Mobile Electronics, Inc. v. Southwestern Bell Mobile Sys.*, 1:02-cv-05403, docket no. 48 (N.D. Ill. March 7, 2003).

¹⁰ *American Logistics Group, Inc. v. Weinpert*, 2005 Ohio 4809, *38 (Ohio App. 8th Dist. 2005).