

# A Survey of the Legal Restrictions on Covenants Not to Compete

Hadar Hannes

## Abstract

Covenants not to compete in employment law are remarkably common in practice. They are becoming increasingly widespread in industries that are highly sophisticated. This legal niche is located in the intersection of contracts and employment law, and is unique in many features.

While the common law tradition strictly prefers the damages remedy to specific performance, in non-competition restrictions specific performance is widely used to enforce covenants whenever the court does not invalidate the restriction. This custom brought commentators to the conclusion that in this area of the law, a damages relief in regards to future harm is almost unavailable. While damages will be awarded for past injury, injunctive relief will usually be the "forward-looking" remedy. Either one wins it all or loses it all.

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*Hadar Hannes: Visiting Researcher at Harvard Law School, Cambridge, MA; Associate at Bach, Arad, Scharf and Co., LLP, Tel-Aviv, Israel.*

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*Send all correspondence to Hadar Hannes, 2 Peabody Terrace #414, Cambridge, MA 02138.*

*Email: [hhannes@law.harvard.edu](mailto:hhannes@law.harvard.edu)*

Although the underlying relationship is seemingly an arms length consensual one, courts and legislators freely compel the parties by mandatory intervening. Moreover, the courts tend to use a case-by-case approach, which hurts the ability to predict the validity of "non-competes". This paper surveys the different legal restrictions on covenants not to compete and arranges them in a manageable framework.

## The History of Covenants Not To Compete

### *The English Common Law Tradition*

A covenant not to compete is a contractual restriction purporting to limit the employee's ability, upon the termination of employment, to compete in the market niche of her employer.<sup>1</sup> Since the common law does not offer injunctive relief for specific performances that restrain workers to a current position, restrictive covenants have been designed to bypass this legal limitation.

Courts have generally disliked non-competition agreements in the field of labor since 1414, when the first recorded case was decided. The defendant, a dyer, was given a bond promising not to practice the trade of dying in the plaintiff's town for a period of six months. The court found the obligation void "because the condition is against

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<sup>1</sup>See L. J. Kutten and Bernard D. Reams, *Executive and Professional Employment Contracts* 89 (Lexis Law Publishing, 1997); *Reddy v. Community Health Foundation of Man*, 298 S.E. 2d 906, 909 n.1 (W.Va. 1982).

common law.”<sup>2</sup> In 1536 the English Parliament passed an “Act for Avoiding of Exaction Taken Upon Apprentices” making it illegal for a master to compel or cause any apprentice or journeyman, by oath or by bond, to promise to refrain from competing with the master.<sup>3</sup> Consequently, in the *Moore* case of 1578, the court determined that a covenant preventing a merchant apprentice from practicing his craft in Nottingham within four years of leaving his master was void.<sup>4</sup>

Further, in *Colgate v. Bacher*,<sup>5</sup> the court voided a bond by an employee to an employer not to practice the trade of haberdashery within the county, or in specific neighboring cities. The court decided that the law forbids a restraint on use (by issue of a bond that will be exercised if the employee does practice haberdashery within the country) of a lawful trade at any time or at any place for it is against the benefit of the commonwealth.<sup>6</sup>

However, in 1711, in the case of *Mitchell v. Reynolds*<sup>7</sup>, which involved a lease of a business, we can find a lengthy discussion of the policy reasons *justifying* upholding a non-competition covenant. The court, upheld a bond that required the defendant not to practice the baker’s art in the same parish for the term of the lease of his bakeshop to the plaintiff. The court found that although there is a presumption that all restraints of trade were invalid, consideration of the condition in the specific circumstances is required. The court attributed its general dislike to non-competition clauses that the restraint placed on the weak. But in the case it was decided that the seller, by agreeing to the restriction not to compete with the buyer of his store, enjoyed a higher price upon selling his business. If the covenant was not enforceable, the buyer would have to lower his purchase price in order to fight the possible competition. This, claimed the court, harms the seller by reducing the best possible price he could hope for. While the *Colgate* case dwelled on the effect of the restriction on the benefits to the commonwealth effects, the court in *Reynolds* ignored this consideration altogether. That is, the social value of the restriction in comparison to its private value was never raised in *Mitchell*.

*Mitchell* also argues that the seller’s ex post infringement of rights is largely law-dependant. If, after a precedent was set, the baker included a void clause in the contract, he could then blame no one but himself for taking such void clause into consideration when setting the contract price. When the court validates covenants not to compete, the buyer should be willing to pay the seller for not competing an amount that is as high as his increased sales from not being subject to competition. On the other hand, the seller will agree not to compete for an amount greater than his benefit from competition. Thus, whenever the buyer gains more from remaining free from competition than the seller loses from not competing, the parties are assumed to reach an agreement to include a non-competition clause.

After *Mitchell v. Reynolds* in 1711, English law always distinguished between post-employment contractual restraints

on employees, and restraints arising out of the sale of a business. The latter were generally upheld, whereas the former were subject to much scrutiny. This approach grew into a “rule of reason” that required judicial balancing of interests.<sup>8</sup>

### **The American History of “Non-Competes”**

Early American Commentaries on non-competition agreements adopted the English viewpoint. Thus, in discussing non-competition agreement, the distinction of *Mitchell v. Reynolds* between general and special restraints was adopted.<sup>9</sup> However, a larger spectrum of considerations, including the public interest, with greater weight to the interests of employees was entertained. General restraints “are universally prohibited...they do mischief to the party by the loss of his livelihood and the subsistence of his family, and mischief to the public, by depriving it of the services and labors of a useful member”.<sup>10</sup> However, specific restraints “not to carry on trade in a particular place, or with particular persons, or for a limited reasonable periods” are valid since this restraint leaves all other places, and persons, and times free for the former employee’s solicitation.<sup>11</sup>

American courts generally did not apply a per-se rule of validity with respect to either post-employment restraints or those associated with the sale of a business.<sup>12</sup> The balancing notion of *Mitchell v. Reynolds* was adopted in the sale of a business area. In *Price v. Fuller*,<sup>13</sup> the plaintiff bought the defendant’s stagecoach. The liquidated damages agreed upon in the contract for breaching events of competition with the buyer in the relevant route were judicially upheld, since it was limited to a specific stagecoach run. This decision is symbolic for two legal trends. First, the court’s attitude is more lax toward covenants not to compete in the sphere of sale of business, especially when they are of limited scope (e.g. specific geographic area). Secondly, while damages set by the court are a rarity in practice, liquidated damages are often honored.<sup>14</sup>

In the case of *Lawrence v. Kidder*,<sup>15</sup> the court voided a non-competition agreement. The court refused to enforce a non-competition covenant not to manufacture or sell palm leaf beds for five years in the entire territory of Albany, New York. In the case of *Dunlop v. Grefory*<sup>16</sup> the court also considered a restriction unreasonable for restricting competition within too broad a territory. According to the Dunlop court, contracts which restrain trade entirely, as is the case of

<sup>8</sup>Ronald J. Gilson, *The Legal Infrastructure of High Technology Industrial District: Silicon Valley, Route 128, and Covenants Not to Compete*, 74 N.Y.U. L. Rev. 575 (1999).51.

<sup>9</sup>Not to compete in the relevant market at all vis-à-vis not to compete in the particular market within a limited geographical area and for a limited period of time or with some individuals.

<sup>10</sup> Storey’s Commentary on Equity Jurisprudence, sec. 292, Little & Brown, 1843.

<sup>11</sup> *Ibid.*

<sup>12</sup> H. Blake, *Employee Agreements Not to Compete*, 73 Harv. L. Rev. 625, 629 (1960).

<sup>13</sup> 8 Mass. 223 (1811).

<sup>14</sup> Gilson also mentions that in Massachusetts “of the ten decision on preliminary injunctions to enforce a covenant not to compete...injunctions were granted in eight”, See Gilson, *supra* note 8.

<sup>15</sup> 10 Bar., 647 (N.Y. Sup. Ct. 1841).

<sup>16</sup> 10 N.Y. 241 (1851).

<sup>2</sup> Dyer’s Case, Y.B. 2 Hen V., Pl. 26 (1536).

<sup>3</sup> 28 Hen, VIII, Ch. 5.

<sup>4</sup> K.B. 115, reprinted in 72 Eng. Rep.47 (Q.B. 1578).

<sup>5</sup> 11 Co. 53, reprinted in 78 Eng. Rep. 1097 (Q.B. 1602).

<sup>6</sup> Also see the case of Blacksmith of South-Mims, 2 Leo. 210, reprinted in 74 Eng. Rep. 347 (Q.B. 1711).

<sup>7</sup> 1 P. Wms. 181, reprinted in 24 Eng. Rep. 347 (Q.B. 1711).

non-competition anywhere within the state, are void. The harm to the public was one of the reasons for the court's decision. However, when the restriction is reasonably limited, under the circumstances, for the necessary protection of the promisee, it may be upheld.

While the previous decisions were in the field of sales of a business, the case of *Keeler v. Taylor*<sup>17</sup> dated 1866 was occupied with non-competition clauses in the employment context. The plaintiff taught the defendant the art of making platform scales. The defendant, on his behalf, obliged to pay the plaintiff, who employed him, a sum of \$50 for each said scale he produces for any person other than the plaintiff, unless he received the consent of the plaintiff. After seven years Taylor, the defendant, decided to open his private practice. The court found the covenant void, as the contract restrained the defendant in an unlimited territory for lifetime, contrary to public policy.<sup>18</sup> It was a restriction on the use of "know how" gained through employment, which resembles today's license. The court believed that this limitation created too broad a restriction to the detriment of the public interest.

To sum up, the history of the American legal approach to non-competition covenants, there is no fixed formula for determining whether a particular non-competition covenant is reasonable and therefore upheld. Hence, precedents have limited value in forecasting the legal result in a specific case.<sup>19</sup> The decision is on an ad-hoc basis, according to the specific circumstances.<sup>20</sup>

Nevertheless, some elements are recognized to be generally considered by courts in determining reasonableness.<sup>21</sup> An unlimited covenant in terms of duration or area is surely to be considered unreasonable and void.<sup>22</sup> Justifications for the covenant such as the harm caused to the employer in the absence of a non-competition requirement are taken into consideration. On the other hand, the economic hardships from which the employee suffers as a result of the contractual limitation are also considered. Further, the court takes into account the employee's ability to continue supporting himself and his next in kin. Finally, the public interest is also weighed.<sup>23</sup> Courts also carefully consider the reasons for the

employer to insist on a noncompetition clause. The list of justification, as described already decades ago, is long and includes: the employee's relations with his employer's customers in terms of good will that might be attributed to the employee<sup>24</sup> in the future, the acknowledgement of the employer's business methods and customer lists,<sup>25</sup> and the protection of the employer's geographical area in which he is doing business.<sup>26</sup>

### **The Fundamentals of the Legal Analysis of Restrictive Covenants**

In the absence of a non-competition clause, a person who leaves his job, is generally entitled to compete with his former employer by himself or by working for a competitor. However, such competition may not misappropriate trade secrets or confidential information acquired during the period of employment.

When there is an explicit clause that forbids the employee from working for a competitor, the courts regard such a restriction with suspicion. The courts explain their disfavor to non-competition clauses on various grounds. For one, the court argues that clauses are written by the employer for his benefit without due economic compensation to the employee.<sup>27</sup> Put differently, courts sometimes argue that the covenants are not priced. This may be the result of unequal bargaining power, irrational bias that results in underestimation of future events or due to an asymmetric information problem. This consideration is also mentioned in the Restatement (Second) of Contracts sec. 188 comment g: "Post-employment restraints are scrutinized with particular care because they are often the product of unequal bargaining

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operated. The court explained that among the elements which should be considered in ascertaining reasonableness of an agreement not to compete are the consideration supporting the agreement, the threatened danger to the employer in the absence of such an agreement, the economic hardship imposed on the employee by such a covenant, and whether or not such a covenant would be inimical to public interest.

<sup>24</sup> *Silver v. Goldberger*, 231 Md. 1, 188 A. 2d 155 (Feb. 1963). Employer, an operator of employment agency, was held not to be entitled to enforce restrictive covenants in employment contracts barring employees from engaging in a competing business for two years after termination of employment. The court determined that there is no justification for restraint where a former employee does no more than become an efficient competitor of his former employer, and does not do so by exploiting his personal contacts with customers or clients of his former employer.

<sup>25</sup> *Donahoe v. Tatum*, 242 Miss. 253, 134 So. 2d 442 (Nov. 1961). The court found that a covenant not to compete with his employer after that employment terminated was reasonable and that there would be no undue hardship on employee, and disclosed no tendency toward monopoly. The evidence proved to the court that Mrs. Donahoe, an employment counselor, who contracted to forbear from competition in Hinds County for five years. Working as a personnel advisor, she was exposed to confidential information, business methods and trade secrets were revealed to her by her former employer, an employment agency. The former employer has suffered, and may suffer in the future, substantial harm if she is permitted to violate the contract.

<sup>26</sup> *Orkin Exterminating Co. v. Dewberry*, 204 Ga. 794, 51 S.E.2d 669 (Jan. 1949). An exterminating company's contract of employment whereby employee agreed not to engage in pest control business or take away employer's customers for one year after termination of contract within 75 mile radius of specified cities, was reasonable as to time limitation but unreasonable and invalid as to territorial limitation. In that case the limitation practically covered the entire state of Georgia and included areas where employer merely anticipated doing business in future.

<sup>27</sup> *See Reading Aviation Service, Inc. v. Bertolet*, 454 Pa. 488, 311 A.2d 628 (1973).

<sup>17</sup> 53 Pa. 467 (1866).

<sup>18</sup> *Ibid* at 470.

<sup>19</sup> Kitten and Reams, *supra* note 1.

<sup>20</sup> *Novelty Bias Binding Co. v. Shevrin*, 342 Mass. 714, 175 N.E. 2d 375.

<sup>21</sup> Kitten & Reams, *supra*, note 1.

<sup>22</sup> *Paramount Pad. Co. v. Baumrind*, 4 N.Y.2d 393, 175 N.Y.S. 2d 809, 151 N.E.2d 609 (June 1958). In that case the court held that contract between company and former employee under which he was not to solicit, as a salesman, Directly or indirectly, company's customers for a period of three years in consideration for payment to him of \$3,000 and he was not to divulge names of company's customers and was to obtain written permission of company before he could accept any position in the industry in which company was engaged, unreasonably prevented former employee from pursuing his occupation where no harm would come to company, and imposed restrictions exceeding degree of protection to which company was entitled in order to preserve its legitimate interests, and contract was contrary to public policy and action could not be maintained for its breach nor for inducing its breach.

<sup>23</sup> *Alltight Auto Parts Inc. v. Berry*, 219 Tenn. 280, 409 S.W.2d 361 (Nov. 1966). In that case the court held that an agreement prohibiting a former employee from competing in the automobile parking business with former employer for a period of five years in any city in which former employer operated was unreasonable and unenforceable, in view of fact area encompassed in the prohibition was beyond that necessary to shield former employer from unfair competition, former employee having been employed as manager of employer in only three of the 46 cities in which former employer

power and because the employee is likely to give scant attention to the hardship he may later suffer through loss of his livelihood. This is especially so where the restraint is imposed by the employer's standardized printed form."

Moreover, courts often consider agreements not to compete a restraint on trade to the detriment of social welfare and find them to be a limit on the right to earn a living.<sup>28</sup> Further disfavor towards restrictive agreements arises because courts argue that these "agreements" have special negative implications since employees become trapped in the relations with their employers.<sup>29</sup>

On the other hand, courts have also realized that non-competition covenants serve useful societal purposes. Courts argue that these covenants encourage employers to provide trade secret information to their employees and prevent employees from gaining an unfair competitive advantage over their former employers. In turn, the employer may increase his overall investments and the investment in the employee's training specifically.<sup>30</sup> Therefore, many jurisdictions enforce such covenants to the extent that they are reasonable in relation to the need of the employer seeking enforcement, the hardship caused to the employee and the effects the covenant has on the public's interests as a whole.

In essence, the enforcement of restrictive covenants represents a balance between two competing interests: protecting the incumbent employer from unfair competition that exploits the employer's investment and the right of an individual to the unhampered pursuit of his occupations and livelihoods for which he is best suited.<sup>31</sup> The question of reasonableness of the restriction is a question of law and not a matter for the determination of the jury as a factual issue.<sup>32</sup>

### **The Different Approaches Among the States**

State law purely governs an action for breach of covenants not to compete.<sup>33</sup> Ad hoc equity justifications usually determine the result of the case at hand, but the level of tolerance of the various states to non-competes is possible to identify and will be further described.<sup>34</sup>

As illustrated in the discussion of the history of restrictive covenants, the courts generally disfavor non-competition covenants. However, the particular approaches vary from

state to state. The reasonableness criterion is used by most states evaluating agreements, but its interpretation differs among states.

There are also differences in the legal treatment that is employed once a non-competition clause is found problematic. Some states draw a clear line between a valid covenant and one that is void, while others call for a judicial modification of unreasonable covenants not to compete. Courts that refuse to modify the restrictive agreement claim that partial enforcement is in effect a judicial rewriting of the contract.<sup>35</sup> They also proclaim that modification, rather than invalidation, would encourage employers to include a broader than necessary non-competition agreement requiring the employee to incur litigation costs in order to narrow the restrictions.<sup>36</sup>

Roughly speaking, courts may apply one of the following rules when analyzing a covenant that restricts competition:

- **An All or Nothing Rule:** Courts applying this rule either wholly invalidate the covenant or validate it "as is."<sup>37</sup>
- **The "Blue Pencil" Rule:** Courts applying the "blue pencil" rule enforce a non-competition clause on a partial term. The court may strike out a phrase to turn the agreement into a reasonable restraint, and thus are arguably not considered to be rewriting the contract.<sup>38</sup>
- **The Rule of Reasonableness of the Interpretation:** This legal doctrine allows the court to rewrite the contract. Once the restriction is determined to be unreasonable, the court will rewrite the contract so there is a reasonable degree of restraint.<sup>39</sup>

While a "blue pencil" rule merely allows the court to strike out phrases in the contract, the rule of reason allows the court to amend the contract until it reaches the reasonableness level. Put differently, while a rule of reason may add a limitation on a certain overly broad restriction, the blue pencil rule may only erase the overly broad sections of a restrictive clause (while other restrictions remain valid). The "all or nothing" rule, on the other hand, will immediately invalidate the entire restrictive clause upon a determination that only part of it is too broad and unreasonable.

A representative sample of the States' current legal views in regards to covenants not to compete follows in alphabetical order. The sample contemplates the wide spectrum of attitudes among the different states.

### **Alabama**

Alabama's statute<sup>40</sup> specifically limits certain employee non-competition agreements:<sup>41</sup>

<sup>28</sup> *W. Miller Const., Inc. v. Schaefer*, 298 N.W. 2d 455, 458 (Minn. 1980): "We have consistently taken a cautious approach to the question whether to permit an employer to enforce a restrictive covenant in an employment contract. Such covenants are looked upon with disfavor because their enforcement decreases competition in the marketplace and restricts the covenantor's right to work and his ability to earn a livelihood."

*Josten's Inc. v. Cuqiet*, 383 F. Supp. 295, 299 (E.D. Mo. 1974): "A covenant that serves primarily to bar an employee from working for others or for himself in the same competitive field so as to discourage him from terminating his employment is a form of industrial peonage without redeeming virtue in the American economic order."

<sup>29</sup> *Fidelity Union Life Ins. Co. v. Protective Life Ins. Co.*, 356 F. Supp. 1199, 1202 (N.D. Tex., 1972).

<sup>30</sup> *Winston Research Corp v. Minnesota Mining & Mfg. Co.* 350 F. 2d 134 (1965). Also see Schulman, *An Economic Analysis of Employee Non-competition Agreements*, 69 Denver U.L.R. 97 (1992).

<sup>31</sup> *Kutten & Reams, supra* note 1, at 15; *Wexler v. Greenberg* 399 Pa. 569, 160 A. 2d 430, 434 (1960).

<sup>32</sup> *Palmer v. Chamberlin* (Ca.5 La.) 191 F.2d 532, 27 A.L.R. 2d 416 (5 Cir. La.) (1951).

<sup>33</sup> *Fry v. Layne-Western Co.* (Ca.8 Mo) 282 F.2d 97 (1960).

<sup>34</sup> *Kutten & Reams, supra* note 19, at 37.

<sup>35</sup> *Phillip G. Johnson & Co. v. Salmen*, 211 Neb. 123, 317 N.W. 2d 900 (1982) at 317 N.W.2d 905.

<sup>36</sup> *Phoenix Orthopaedic Surgeons Ltd. V. Peairs*, 164 Ariz. 54, 790 P.2d 752, 1990 Ariz. App. LEXIS 323.

<sup>37</sup> See Peter Panken, *Employment and Labor Law*, 23 (8th ed., 1998, ALI-ABA) Howard Schultz & Associates, Inc. v. Broniec (1977) 239 Ga. 181, 236 S.E.2d 265.

<sup>38</sup> *Hartman v. W.H. Odell and Assocs. Inc.* 450 S.E.2d 912, 920 (N.C. Ct. App. 1994).

<sup>39</sup> *Baxter Intern. Inc. v. Morris*, 976 F.2d 1189, 1992 U.S. App. LEXIS 25486 (8th Cir.). See also *The Phone connection, Inc. v. Harbst*, 494 N.W.2d 445 (Iowa App. 1992).

<sup>40</sup> Ala. Code §8-1-1 (Michie 1993).

Sec. 8-1-1-(1975) voids any contract restraining business, except in specific circumstances.

- 1) Every contract by which anyone is *restrained* from exercising a lawful *profession, trade or business* of any kind otherwise than is provided by this section is to that extent *void*. (emphasis added)
- 2) *One who sells* the good will of *business* may agree with the buyer and *one who is employed* as an agent, servant or employee *may agree* with his employer to refrain from carrying on or engaging in a *similar* business and from carrying on or engaging in a similar business and from *soliciting* old customers of such employer within a *specified county, city or part thereof so long as* the buyer, or any person deriving title to the good will from him, or employer carries on a like business therein. (emphasis added)
- 3) Upon or in anticipation of dissolution of the *partnership, partners may agree* that none of them will carry on a similar business within the same county, city or town, or within a specified part thereof, where the partnership business has been transacted. (emphasis added)

The Alabama court was willing to apply the “blue pencil rule”, and narrowed the scope of overly broad restrictions.<sup>42</sup> Emphasis should be put on the omission of the word “profession” restraint from subsection (2) which validates covenants that qualify the requirements. The court interpreted this as an indication for a legal invalidation of restraints of professionals’ employment. Thus, Alabama’s courts, in some cases, found physicians<sup>43</sup> and accountants<sup>44</sup> to be professionals, but not bankers,<sup>45</sup> insurance salesmen<sup>46</sup> and marketing vice presidents.<sup>47</sup>

The courts of Alabama, in a line of cases, announced their disfavor to restraints upon an individual’s employment in any manner. The court requires the employer to have an interest reasonably protected in the restriction and reasonably limited in place and time, without causing undue hardship to the employee.<sup>48</sup>

## Alaska

There is no state statute governing the issue of covenant not to compete in Alaska. The court considers the reasonableness of the contractual limitation, according to the geographical boundaries of the limitation, its length in time, as well as the effect of restricting the employee’s mobility on competition in the relevant market.<sup>49</sup>

<sup>41</sup> Covenants Not to Compete in Alabama: Revisited, 53 Ala. Law, 180 at 18 (1992).

<sup>42</sup> See *Ex parte Caribe, U.S.A., Inc. v. Caribe, U.S.A., Inc.*, 702 So. 2d 1234 (1997), in which the court narrowed a five year restrictive agreement to three years.

<sup>43</sup> *Associated Surgeons, P.A. v. Watwood*, 295 Ala. 229, 326 So. 2d 721 (1976).

<sup>44</sup> *Burkett v. Adames*, 361 So. 2d 1, 3 (Ala. 1978).

<sup>45</sup> *Central Bank of the South v. Beasley*, 439 So. 2d 70 (Ala. 1983).

<sup>46</sup> *Hoppe v. Preferred Risk Mutual Ins. Co.*, 470 So. 2d 1161 (Ala. 1983).

<sup>47</sup> *Parker v. EBSCO Indus. Inc.* 282 Ala. 98, 209 So. 2d 383 (1968).

<sup>48</sup> *Calhoun v. Brendle Inc.* 502 So. 2d 689, 691 (Ala. 1986). See also *Central Bancshares of the S. v. Puckett*, 584 So. 2d 829, 831, 6 (Ala. 1991).

<sup>49</sup> See *Data Mgmt. V. Greene*, 757 P.2d 62,65 (Alaska, 1988) and *Wirum & Cash, Architects v. Cash*, 837 P.2d 692, 711 (Alaska, 1992).

## Arizona

In Arizona there is no governing statute dealing with covenants not to compete. Again, the court examines the reasonableness in time and space, the legitimate interest of the employer, the rights of the employee and public policy considerations such as competition and mobility of employees.<sup>50</sup>

## California

California is the best example for harsh mandatory restraints on anti-competitive covenants.<sup>51</sup> California has a fierce statutory prohibition on non-competition covenants. Section 16600 of the California Business and Profession Code<sup>52</sup> states:

“Unauthorized contracts: Except as provided in this chapter, every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void”.

In *Application Group, Inc.* the court determined that an employer who uses an unlawful, and therefore, void, restrictive covenants in employment law can be found to be conducting unlawful business practices according to California Unfair Practices Act § 17200 *et seq.*

Authorized restrictions are very limited. California’s courts enjoin a former employee from competing, on equity grounds, if it finds unwarranted disclosure of trade secrets<sup>53</sup> or if the covenant is required to prevent unfair competition.<sup>54</sup> Gilson explains that California adopted the UTA (now called the UTCA), but that litigation is “expensive and slow”, and involves great “uncertainty associated with a jury trial of

<sup>50</sup> See *Oliver / Pilcher Ins. v. Daniels*, 148 Ariz. 530, 715 P.2d 1218, 1220 (1986) and *Phoenix Orthopaedic Surgeons v. Peairs*, 790 P.2d (Ariz. Ct. App. 1989). See also *Hile, Rogal and Hamilton Company. Of Ariz. V. McKinney*, 946 P.2d 464 (Ariz. Ct. App. 1997).

<sup>51</sup> A more lax approach has been apparent in the context of the sale of a business, subjecting restrictive covenant in that context to the reasonableness test. See *Monogram Indus. v. SAR Indus.*, 64 Cal. App. 3d 692, 697-98, 134 Cal. Rptr. 714, 718 (1976).

<sup>52</sup> Cal. Bus. & Prof. Code §16600-16602.5 (Bancroft-Whitbey 1992 & Supp. 1995).

A partnership agreement requiring a geographic limitation on competition has been enforced in accordance with section 16602: “Any partner may, upon or in anticipation of a dissolution of the partnership, agree that he will not carry on a similar business within a specified county or counties, city or cities, or a part thereof, where the partnership business has been transacted, so long as any other member of the partnership, or any person deriving title to the business or its goodwill from any such other member of the partnership, carries on a like business therein”. In *Howard b. Babcock*, 6 Cal. 4th 409, 415-26, 863 P.2d 150, 154-61 (Cal. 1993) the court found the partnership exception applicable to lawyers.

The 1995 supplement, effective Sept. 30, 1994, states an exception to the statutory restriction on covenant not to compete, in the context of a dissolution of a limited liability company: “Any member may, upon or in anticipation of a dissolution of a limited liability company or a sale of his or her or its interest in a limited liability company, agree that he or she or it will not carry on a similar business within a specified county or counties, city or cities, or a part thereof, where the limited liability company business has been transacted, so long as any other member of the limited liability company, or any person deriving title to the business or its goodwill from any such other member of the limited liability company, carries on a like business therein”.

<sup>53</sup> *Ruvolo & Kaschnitz, The dreaded ‘Scott’ Decision – The Status of Enforcing Non-Competition Covenants in California*, Fracise L.J. 45 (Fall 1992).

<sup>54</sup> *Metro Traffic Control, Inc. v. Shadow Traffic Network*, 22 Cal. App. 4th 853 (1994).

technical issues”.<sup>55</sup> Therefore, Gilson argues that “on balance, trade secret law does not provide a significant barrier to high velocity employment and, at least in California, it apparently has not.”<sup>56</sup> Gilson also argues “actions in response to theft and industrial espionage...are not subject to the same level of ambiguity associated with efforts to restrict employee mobility. Significant protection is provided against departing employees in circumstances where the misappropriation is clear (as when the former employee has removed or copied document), the technology obviously is confidential, and the damage to the business substantial.”<sup>57</sup> He continues to argue that “it remains the case that protection is limited”. With no evidence as required by the act, the California court offers no remedy to the employer.

The California courts have rigorously enforced section 16600, invalidating agreements that an employee will not work for a competitor upon completion of his or her employment.<sup>58</sup> Thus, a federal court emphasized that “section 16600 should be interpreted as broadly as it reads”<sup>59</sup> and refused to apply a rule of reason in interpreting a covenant restraining competition under section 16600.<sup>60</sup>

## Colorado

Colorado Rev. Stat. §8-2-113(2) and (3)<sup>61</sup> sets a general prohibition on non-competition agreements in employment, with exceptions in regards to non-competition covenants in the following:<sup>62</sup>

- 1) The sale of a business;
- 2) The protection of trade secrets (but not to an extent that it restricts employment, beyond such protection);
- 3) The recovery of training expenses if the employer terminates employment within two years of employment (but the covenant ceases upon repayment of these expenses);

<sup>55</sup> Gilson, *supra* note 8 at 28, 29.

<sup>56</sup> Gilson, *supra* note 8, at 32.

<sup>57</sup> Gilson, *ibid*, note 8 at 32.

This seems to imply that the mobility in those cases is not overall socially efficient, but is merely a distribution matter from the former employer to the new one.

<sup>58</sup> R. Mainland, *Contracts Limiting Competition by Former Employees: A California Law Perspective*, 340 PLI/Pat 119, 123.

<sup>59</sup> However, in *General Commercial Packaging, Inc. v. TPS Package Eng'g, Inc.*, 126 F.3d 1131, 1132-34 (9<sup>th</sup> Cir. 1997), the court enforced a one year non-competition agreement between a contractor and its subcontractor that proscribed the subcontractor from directly providing work for any other contractor's clients because the agreement did not preclude the subcontractor from “engaging in its trade or business”. See Karen E. Ford, Kerry E. Notestine, Richard N. Hill, *Fundamental of Employment Law* (2<sup>nd</sup> ed., 2000).

<sup>60</sup> *Scott v. Snelling and Snelling, Inc.*, 732 F. Supp. 1034, 1042 (N.D. Cal. 1990).

Also see *Ware v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 24 Cal. App. 3d Cal. App. 3d 35, 100 Cal. Rptr. 791 (1972), *Trade Cases* P 74, 136 (Cal. App. 1 Dist., March 1972) (invalidating under section 16600 a profit sharing clause forfeiting a former employee's benefits if he engaged in a competitive occupation; *Muggill v. Reuben H. Donnelley Corp.*, 62 Cal. 2d 239, 42 Cal. Rptr. 107 (1965) (refusing to enforce a retirement plan provision terminating annuity payments of retired employee who enters competitive business). *Beneficial Life Insurance CO. v. Knoblauch*, 6533 F.2d 393 (9<sup>th</sup> Cir. 1981) (invalidating a provision of an employment contract requiring the departed employee to repay advances upon entering a competing business).

<sup>61</sup> Colo. Rev. Stat. § 8-2-113(2) and (3) (Bradford 1986) Repl. Vol. 3B.

<sup>62</sup> Colo. Rev. Stat. § 8-2-113-(2) and § 8-3-13-(3) (1984 Pocket Supp.). See Powers, *Drafting Noncompete Covenants: Statutory and Common Law Constraints*, 13 Colo. Law Rev. 757 (1984).

- 4) The contract entered into by management personnel and their professional staff<sup>63</sup> (if the employee has the “knowledge, skills or license for the successful conduct of business and is a significant factor involved in the business);<sup>64</sup>

Non-competition covenants restricting physicians from practicing medicine are unenforceable under subsection (3) of the Colo. Rev. Stat.; however, payment of damages for a breach of such agreement is attainable under this subsection.

Non-competition agreements that may be validated under the Colorado statute will be judged according to common law tests.

Under the Colorado statute, the reasonableness of any covenant is analyzed using a two-step approach, taking into consideration the specific circumstances of the case. First, a covenant must justifiably protect a valid interest of an employer. Second, the specific covenant must be reasonable. Knowledge of trade secrets and confidential information, relations with customers and knowledge of their needs were considered a valid interest of an employer. Special training of the employee, as well as the fact that the employee may be a key employee also support the reasonableness of a non-competition agreement. So is the mere fact that the employer's business is highly technical and competitive.<sup>65</sup>

Once the court determines the issue of reasonableness, it either grants an injunction or denies one. It thus employs the “all or nothing” rule rather than the “blue pencil” or “rule of reasonableness in interpretation”.<sup>66</sup>

Interestingly, Colorado courts refuse to enforce the non-competition agreement if there is no deliberate<sup>67</sup> breach, and if there is a good faith attempt by the employee to remove any indications of his prior affiliation with the former employer. They also do not enforce a restrictive covenant that is not limited geographically or in time.<sup>68</sup> On one occasion, the Colorado court struck down a 50 percent liquidated damages clause for a period of two years in an anesthesiologist's practice.<sup>69</sup>

## Louisiana

Non-competition agreements are not favored in Louisiana. They are viewed as being against public policy unless provided otherwise by the statute.<sup>70</sup> Notwithstanding the statute<sup>71</sup>, Louisiana courts enforce non-competition covenant in order to protect customer lists (other than by memory) and

<sup>63</sup> Legal, engineering, scientific and medical personnel as well as their junior staff: *Porter Industries Inc. v. Higgins*, 680 P.2d 1339, 1342 (Colo. App. 1984).

<sup>64</sup> Powers, *supra* note 50 at 762.

<sup>65</sup> Kutten & Reams, *supra* note 1, at 44.

<sup>66</sup> See page 12.

<sup>67</sup> The terms “deliberate” and “clear” breaches are very vague. Moreover, it seems that the intent of the employee should not play a significant role, unless the employee had such intent at the time he signed it.

<sup>68</sup> *Management Recruiters of Boulder v. Miller*, 762 P. 2d 763, 766, 3 IER cases 1265 (Colo. App. 1988).

<sup>69</sup> *Wojtowicz v. Anesthesia Services, P.C.*, 961 P.2d 520 (Colo. App. 1998).

<sup>70</sup> *LaFourche Speech & Language Servs. Inc. v. Jucket*, 652 So. 2d 679, 680 (La. App. 1 Cir. 1995).

<sup>71</sup> La. Rev. Stat. Ann. 23:921 (West Cum. Supp. 1994) and 1989 La. Acts, No. 629 §1.

trade secrets. However, if the termination of the employment is without cause, the restriction is frequently not enforced.<sup>72</sup>

Any territorial protection is limited to two years.<sup>73</sup> The Louisiana statute explicitly requires investment on behalf of the employer to justify the employer's protection.<sup>74</sup> However, consideration paid for the employment was determined to suffice for such proof.<sup>75</sup>

## Massachusetts

Massachusetts is an example of a state that is quite permissive regarding non-competes. In Massachusetts there is no state legislation that governs the enforceability of covenants not to compete. Case law uses the guidelines of the restatement, discussed in the next section, in enforcing these covenants.

Massachusetts's courts enforce covenants to the extent that they are reasonable to protect the legitimate business interests of the former employer.<sup>76</sup> Of the ten decisions on preliminary injunctions to enforce a covenant not to compete between February 1994 and July 1996, injunctions were granted in eight.<sup>77</sup> Legitimate business interests that may justify restrictions on competition include trade secrets, confidential data, and goodwill (generally applied to customer relationships).<sup>78</sup> The court enforces restrictions it finds to be reasonable. The courts apply the "rule of reasonableness in interpretation" to reduce the impact of the restrictions in order to make the covenant enforceable.<sup>79</sup> The courts are not bounded by the blue pencil doctrine nor by the "all or nothing" in making covenant enforceable. Hence, in *Kroeger v. Stop & Shop Cos.* the trial court modified an overbroad covenant that, as written, purported to bar a former employee from competing anywhere east of the Mississippi River, except for designated states. The court modified the covenant to allow the former employee to work in New England, New Jersey, and New York – areas in which the employer had never operated. The court also modified the time term, which purported to restrict the employee for life, by reducing the covenant's proscriptive period to 1 year.<sup>80</sup>

## Montana

Montana law generally voids any contract by which anyone is restrained from exercising a lawful profession, trade or business of any kind.<sup>81</sup> Trade secrets and confidential information, however, are protected to the extent they are inaccessible to others. Customer lists are considered confidential if it was purposely memorized or otherwise copied. However, if using such information is not in violation of the former

employer's confidence, the court will not enforce the restriction.<sup>82</sup>

In the case of *Best Dairy Farms, Inc. v. Houchen*<sup>83</sup> the court refused to issue an injunction against an employee who solicited customers, because information was accessible to the public. This policy was later followed in the case of *First Am. Ins. Agency*,<sup>84</sup> with a further explanation that the information was part of the employee's general knowledge gained through employment. However, in the case of *Dequire & Tucker v. Rutherford*,<sup>85</sup> the court upheld a liquidated damages provision, claiming it did not restrain the employee from engaging in public accounting or from using confidential information obtained during the course of the employment.

## Nevada

Nevada Revised Statute §613.200 does not generally forbid non-competition agreements. However, such agreements may only result in a damages award.<sup>86</sup> The statute is applicable only in regards to those seeking employment with others, and not to those who enter competition via self-employment. The rule of award of damages as the remedy and the absence of injunctive relief are exceptions to the legal practice of other states. However, when self-employment is at hand, the statute does not limit the remedy to damages.

Nevada Revised Statute §598A.010-280 make up the Nevada Unfair Trade Practices Act (NUTPA), which prohibits restrictions on trade, presumably including unreasonable restrictive covenants.<sup>87</sup>

## New York

In New York there is no legislation that governs the enforceability of covenants not to compete. In the 1847 codification, David Dudley Field, was charged to revise, reform, simplify and abridge the rules of the courts of record of the state.<sup>88</sup> While a revolutionary civil procedure code was promptly enacted, the Civil Code Field produced, was never enacted due to controversies associated with it. Interestingly, his proposed New York Civil Code was adopted in California.<sup>89</sup>

In New York, an employer has a legitimate interest in protecting its trade secrets and confidential customer information.<sup>90</sup> The court also protects goodwill of the employer's business and relief may further be available where an employee's services are unique or extraordinary, such as the way he sings.<sup>91</sup> To be enforced "the anticompetition covenant in employment contracts will be enforced only if they are geographically and temporally reasonable, and then only to

<sup>72</sup> *Neeb-Kearney & Co. v. Rellstab*, 593 So. 2d 741, 749, 594 So. 2d 1321 (La. 1992).

<sup>73</sup> *Cellular One, Inc. v. Boyd*, 653 So. 2d 30,33 (La. App. 1995).

<sup>74</sup> *Orkin Exterminating Co. v. Foti*, 302 So.2d 593 (La. 1974).

*Chalmers Corp. v. Camell*, 479 So. 2d 990 (La. App. 1985).

<sup>75</sup> *Allied Bruce Terminiz Co., Inc. v. Guillory*, 649 So. 2d 652, 653 (La. App. 3 Cir. 1994).

<sup>76</sup> *Shiple Co. v. Clark* 728 F. Supp. 818,826 (D. Mass, 1990).

<sup>77</sup> *Gilson*, *supra* note 8.

<sup>78</sup> *Kroeger v. Stop & Shop Cos*, 13 Mass. App. 310, 432 N.E. 2d 556 (1982); *Middlesex Neurological Assocs. V. Cohen*, 3 Mass. App. 126, 324, N.E.2d 911 (1975).

<sup>79</sup> P. J. Richey, *Covenants Not to Compete, A State by State Survey*, 300.

*S. App. 310, 432 N.E.2d 566 (1982).*

<sup>81</sup> *Mont. Code Ann. §28-2-703-704 (1995).*

<sup>82</sup> *First Am. Ins. Agency v. Gould*, 661 P.2d 451, 454 (Mont. 1983).

<sup>83</sup> 152 Mont. 194, 448 O.2d 158, 160 (1968).

<sup>84</sup> *Supra*, note 82, at 453.

<sup>85</sup> 708 P.2d 577 (Mont. 1985).

<sup>86</sup> Nevada Revised Statute §613.200.

<sup>87</sup> *See Ford et al, supra* note 59. For the unreasonableness test, *see Comco, Inc. v. Baker*, 936 P.2d 829, 832 (1997).

<sup>88</sup> *Gilson, supra* note 8, at 48.

<sup>89</sup> It was in Section 833 of Field's proposed New York Code, adopted by the California legislature in 1872, that we find the precursor of Business and Professions Code section 1660.

<sup>90</sup> *Orkin Exterminating Co. v. Dayton*, 140 A.D.2d 748, 749, 527 N.Y.S.2d 883, 884 (1988); *Primo Enter v. Bachner*, 148 A.D.2d 350, 351, 539 N.Y.S.2d 320, 321 (1989).

<sup>91</sup> *Walter-Karl Inc. v. Wood*, 137 A.D.2d 22, 27, 528 N.Y.S.2d 94, 97-98 (1988).

the extent they are necessary to protect the employer from unfair competition resulting from the use of trade secrets or confidential customer lists.”<sup>92</sup>

### North Carolina

Section 75-4 of the North Carolina Code<sup>93</sup> deals with non-competition clauses in employment. The statute requires that the agreement be in writing, reasonable in time and territory, ancillary to the employment contract, based on valuable considerations, protect legitimate interests of the employer<sup>94</sup> and not be against public policy.<sup>95</sup> Customer lists, price lists, “hard knowledge” of process and research as well as development information may all be considered legitimate employer’s interests according to North Carolina. So is the knowledge of employer’s contacts with customers. In the case of *Whittaker Cen. Medical Corp. v. Daniel*,<sup>96</sup> the court determined that it would not rewrite or enforce an overly broad non-competition agreement.<sup>97</sup> However, the court further announced that if the contract were separable the court would enforce the reasonable provision.

### North Dakota

North Dakota Cent. Code sets a broad prohibition on non-competition covenants in employment.<sup>98</sup> In 1993 the North Dakota court extended this policy. In the case of *Werlinger v. Mutual Service Casualty Ins. Co.* the court found the contract restrained the employee from competing by requiring that he “purchase the freedom to compete...by forfeiting money that MSI would otherwise pay him” and therefore invalidated it.<sup>99</sup>

### Oregon

Chapter 653.295 of Oregon’s Revised Statute enforces specific restraints on trade (limited specialization within the profession, limited geographic area and period of time, specific customers), while it refuses to do so in regard to general restraints (restricting any job within the profession in general – e.g. working as a computer engineer in high tech and not only in the semiconductors field)<sup>100</sup>. Consideration of employer’s interests, the reasonable limitation of the restriction, as well as public interest are all weighed. The court is also ready to modify a covenant that extends the restraint beyond reasonable limits.

In Oregon, consideration supports a covenant not to compete that is executed upon initial employment, at the time of the commencement of work.<sup>101</sup> In *Pacific Veterinary Hosp. P.C. v. White*<sup>102</sup>, the court determined that covenants initially

entered into upon employment, but subsequently modified are void.

### Wisconsin

Under the language of the Wisconsin statute<sup>103</sup> unreasonably broad covenants not to compete are void. Public interest is considered unaffected as long as the constraint does not stifle competition, create a monopoly, or create a shortage of employee.<sup>104</sup> Any restrictive covenant imposing an unreasonable restraint is illegal, void and unenforceable and the court determined that the act prohibits the “blue pencil” rule.<sup>105</sup>

### The Reasonableness Standard

In evaluating the reasonableness of the restraint, courts consider multiple aspects of the particular case at hand. While the specific state law determines the state’s approach, as discussed above, the guidance of the Restatement of Contracts sheds light on the list of issues that are considered.<sup>106</sup> Roughly speaking, the reasonableness test can be framed by three questions aimed to uncover the nature of the contractual covenant:

- 1) Is it within the necessary limits to protect the employer’s legitimate interest?
- 2) Is it not unduly harsh and oppressive on the employee?
- 3) Is it not injurious to the public?

The court weighs these three factors in evaluating the reasonableness of the restriction. Each of these are presented below.

### The Employer’s Legitimate Interests

Traditionally, the following interests were considered legitimate for protection: Trade secrets; good will; unique service by the employee and immense investment in the training of the employee.

Protection of trade secrets is based on the desire to give an enterprise proper incentive to conduct research with confidence that the trade secrets will not be revealed to competitors, unless it willfully decides to exchange ideas.<sup>107</sup>

The employee’s duty not to disclose confidential information, which extends beyond the period of employment, is also protected by the fiduciary duty of the employee. However, a non-competition clause relieves the employer of the burden of proving that the employee’s competition is detrimental to the protection of the trade secret and protects information regarding trade secrets that is not clearly confidential.<sup>108</sup>

<sup>92</sup> *Altana Inc. v. Schansinger*, 111 A.D.2d 199, 489 N.Y.S.2d 84 (1985).

<sup>93</sup> N.C. Gen. Stat. §75-4 (Michie 1994).

<sup>94</sup> *Hartment v. W.H. Odell and Assocs. Inc.* 450 S.E.2d 912, 919 (N.C. Ct. App. 1994).

<sup>95</sup> *Nalle Clinic Company. V. Parker*, 101 N.C. App. 341, 399 S.E.2d 363, 366, 6 IER Cases 158 (1991).

<sup>96</sup> 523, 379 S.E.2d 824, 1989 N.C. LEXIS 299. Comment, *Injunctive Russian Roulette and Employment Non-competition Cases*, 63 N.C. L. Rev. 222 (1984).

<sup>97</sup> *Id.*

<sup>98</sup> N.D. Cent. Code, §9-08-06 (Michie 1987).

<sup>99</sup> 496 N.W.2d 26, 1993 N.D. 29.

<sup>100</sup> Or. Rev. Stat. §653.295 (1993).

<sup>101</sup> *Olsten Corp. v. Sommers*, 534 F. Supp. 395, 397 (D. Or. 1982).

<sup>102</sup> 72 Or. App. 533, 696 P.2d 570, 572.

<sup>103</sup> Wis. Stat. Ann. (1988) (IERM 592:11).

<sup>104</sup> *Nalco Chemical Co. v. Hydro Technologies Inc.*, 984 F.2d 801, 1993 U.S. App. LEXIS 1195 (7<sup>th</sup> Cir.).

As I will describe there is a much broader spectrum of considerations that require regard, within the public interest and social efficiency.

<sup>105</sup> *Streiff v. American Family Mut. Ins. Co.*, 118 Wis.2d 602, 348 N.W.2d 505, 509 (1984).

<sup>106</sup> Restatement (Second) of Contracts sec. 188(1)(1981).

<sup>107</sup> See M. Tsatalis & T. Klima, *Protecting Trade Secrets from Malicious Employees*, Legal Documentation for Start-Up and Emerging Companies (1997).

<sup>108</sup> R. Merges, P. Menell, M. Lemley & T. Jorde, *Intellectual Property in the New Technological Age* 89 (1997) (“In a competitive industry, preventing the disclosure of trade secrets is far preferable to suing for misappropriation after

Goodwill and customer lists are protected as proprietary interests.<sup>109</sup> It is intended to create an incentive to offer genuine output (service or goods) and enjoy the benefits of the goodwill thus created with the protection from the employee's competition. Otherwise, the employee may end up free riding on the investment to create the goodwill on the account of the investing employer. Professional connections, however, are considered general experience, which the employee may generally freely use.<sup>110</sup>

The argument of uniqueness is based on the grounds that the employer invested in the employee and is eligible not to lose an excellent employee. This is of course not a stand-alone justification, as it might punish those who succeeded without weighing the benefit to the public from the mobility of such an employee. Qualifying to be within this category are media personalities or sports.<sup>111</sup>

The investment in the education or training of the employee requires protection from exploitation of the knowledge he acquired to the detriment of the investor. The public interest advocates such investment that would satisfy the employer's interest and therefore the law should create proper incentives that enable recouping the investment.<sup>112</sup> To qualify under this exception, extensive and costly training in a specialized field is required.<sup>113</sup>

It should be mentioned that if the court finds that the restriction of the employer is based on the desire to constrain the use of personal skills of the employee, including his knowledge of the employer's business methods ("know how"), the court would not enforce such restriction.<sup>114</sup>

### **Oppression of the Employee**

Within this consideration, the period of employment restriction and the geographic area of limitation will be considered, as well as the scope of the activity limited.<sup>115</sup> The courts recognized that a restricting covenant not only limits the freedom of the employee's professional mobility, but also tends to reduce the employee's freedom to seek better conditions. Once the employee is limited in her choices to work elsewhere, she is at the mercy of her employer who is free to behave opportunistically towards the employee during the employment relationship.

In the sphere of high tech, the life cycle of the "knowledge" product is substantially limited, and a limitation of even

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they have already been disclosed, A noncompetitive agreement may be a reasonable way for an employer to prevent a problem – and a lawsuit – before it starts").

<sup>109</sup> Hitchcock v. Coker 112 E.R. (1837) 167 at 174-5.

<sup>110</sup> Philip Hunke, D.D.S. v. Wilcox, 815 S.W.2d 855, 1991 Tec. Civ. App.LEXIS 2172.

<sup>111</sup> King Records, Inc. v. Brown 21 A.D.2d 593, 252 N.Y.S.2d 988 (1964) Bradford v. N.Y. Times Co. 501 F.2d 51 (2d Cir. 1974).

Moore Business Forms Inc. v. Foppiano, 382 S.E.2d 499, 1989 W. Va. LEXIS 108. ABC Mobile Brakes v. Leyland, 84 A.D.2d 914, 446 N.Y.S.2d 660(1981).

Smith, Waters, Kuehn, et al. V. Burnett, 192 Ill. App.3d 693, 548 N.E.2d 1331, 139 Ill. Dec. 617, 1989 Ill App. LEXIS 1922.

<sup>112</sup> P. H. Rubin & P. Shedd, *Human Capital and Covenants Not to Compete*, 10 J. Leg. Stud. 93 (1981).

<sup>113</sup> Nationwide Mutual Ins. Co. v. Cornutt, 907 F.2d 1085, 1990 U.S. App.LEXIS 12687 (11<sup>th</sup> Circuit).

<sup>114</sup> Herbert Morris Ltd. V. Saxelby 1 A.C. 688, 714 (1916) (H.L.).

<sup>115</sup> HCCT Inc. v. Walters, 99 Ohio App. 3d 472, 651 N.E.2d 25,27 (1994). Cox v. Simon, 278 N.J. Super. 419, 651 A.2d 476,480 (1995).

merely one year may pose a major obstacle for the employee.<sup>116</sup>

### **Public Welfare**

Within the public interest consideration, the court would weigh the interest of freedom of contracts, which leads to a desire for minimal intervention of the law in invalidating covenants not to compete.<sup>117</sup> If, for example, an employer cannot protect himself from the harm of the mobility of his employee, he might hire fewer employees and inefficient production would result. In turn, consumer welfare is reduced.

While courts in the past claimed that "restraint of employment tends to deprive the public of efficient service",<sup>118</sup> later courts did not find the deprivation of the employee's service to be against the public interest since in most cases, the service can be provided by someone else.<sup>119</sup> However, the deprivation of a public service was more likely to be realized by the court where restrictions on physicians or lawyers were at stake.<sup>120</sup> In the case of *Ellis v. McDaniel*,<sup>121</sup> for example, the court invalidated a restrictive covenant that denied the residents of Nevada their only orthopedic surgeon. Further, in the case of *Medical Specialists Inc. v. Sleweon*<sup>122</sup>, the court held that the agreement not to compete adversely affects the public.

In the labor market for lawyers, the court may also prohibit certain restrictive covenants. In the case of *Schuhalter* the court rejected such a claim in regards to accountants, but claimed that in professions such as medicine and law, the relations "are so personal and confidential...as to prohibit restrictive covenants which impinge on the public's right of free access to the professional of its choice."<sup>123</sup>

### **Remedies Offered**

Presently, courts in the vast majority of jurisdictions have placed themselves in a position where they must either grant an injunction, or invalidate the covenant. This is the primary remedy both sought and granted against breach of post-employment non-competition agreements.<sup>124</sup> While damages

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<sup>116</sup> Kuttan & Reams, *supra* note 1, at 105.

<sup>117</sup> Kuttan & Reams, *supra* note 1, at 107.

<sup>118</sup> Kadis v. Britts, 224 N.C. 154, 29 S.E. 2d 543, 546 (1944).

<sup>119</sup> Canfield v. Spear, 44 Ill. 2d 49, 254 N.E.2d 433, 435 (1969).

<sup>120</sup> Branson Ultrasonics Corp. v. Stratman, 921 F.Supp. 909, 913 (D. Conn. 1996).

<sup>121</sup> 596 P.2d 222 (Nev. 1979).

<sup>122</sup> 652 N.E.2d 517, 526 (Ind. App. 1995).

<sup>123</sup> Schuhalter v. Salerno, 279 N.J. Super. 504, 653 A.2d 596, 598 (1995).

<sup>124</sup> Michael Trebilcock, *The Common Law of Restraints of Trade: A Legal economic Analysis* (1986), 77. Gilson, *supra* note 8. Also see R. Meges, et al., *supra* note 108 at 89: "A non-competition agreement may be a reasonable way for an employer to prevent a problem – and a lawsuit before it starts". For examples in some states see:

Technicolor v. Traeger, 57 Haw. 116,117,551 O.2d at 166, 167 in which the court enforced a three year covenant extending throughout Hawaii protecting customer lists and pricing information. Evidence of Hardship to the employee did not invalidate the covenant.

A majority of Colorado decisions have enforced non-competition covenants (Supra, note 17 at 44). See for example *Gulick v. A. Robert Strawn & Assoc., Inc.*, 477 P.2d 489, 492 (Colo. App. 1970). Once the reasonableness of a covenant is determined, the court will either automatically grant an injunction or deny an injunction upon an absence of any irreparable harm, but may award damages after trial.

may be granted, this remedy is used for past injuries along with the injunctive relief, if granted, and not as a remedy for itself. The existence of a liquidated damages clause is not common, though enforceable. Liquidated damages define the limit of damages recoverable for past injury,<sup>125</sup> and therefore parties are sometimes reluctant to limit themselves. The scope of damages may be unpredictable. Moreover, a liquidated damages clause in an employment contract may preclude the former employer from getting an injunctive relief.<sup>126</sup>

In regards to the employer's investment, a possible remedy to is a promissory note for the training expenses. According to the note's terms, the training expense is forgiven upon termination of employment by the employer or after the employee has worked for a certain period of time.<sup>127</sup> Since this note is a mechanism to enforce the covenant not to compete and is due only if the covenant is breached, the validity of the non-competition agreement is essential to the collection of the note.<sup>128</sup> While this is a remedy that the court is willing to accept, it is not too common for the parties to include such a consensual remedy since it is hard for the parties to evaluate the costs and benefits in advance.<sup>129</sup> Therefore, private parties prefer in most cases to leave the relief for ex post evaluation of the court.

In regards to the allocation of risk argument, negotiating in advance for the employer's risk of employee disclosure creates the problems of ex-ante valuation, mentioned above in regards to the investment costs, as well as liquidity constraints, thus rendering this option infeasible. Moreover, it is difficult to specify which activity exactly is constrained. A restrictive covenant can hardly be efficient in the presence of incomplete information. This is both in regards to the value of the trade secret, which is unknown until after the employment agreement has been entered into, and in regards to the estimation of the likely value of customer connections.<sup>130</sup>

## Conclusion

Covenants not to compete frequently find their way into the courtroom. The survey conducted in this article sheds light on some of this phenomenon. Non-competes are extremely popular, but the legal restrictions on them are a vague concept. On the one hand, courts comprehensively scrutinize the private parties' intentions, but on the other hand, when a non-compete is validated, the injunction remedy is quite generously obtained.

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In Florida the court either found the restrictive agreement overly broad and unenforceable, (and did not award damages) (*Cherry, Bakaert & Holland v. LaSalle*, 413 So.2d 436, 438 (Fla. App. 1982) or modified it to be enforceable: *Pinch-A-Penny of Pinellas County v. Chango* 557, So. 2d 940, 1990 Fla. App. LEXIS 1431 and *Santana Prods. Co. v. Von Korff*, 573 So. 2d 1027 (Fla. App. 2d Dist. 1991), 1991 Fla App. LEXIS 683.

<sup>125</sup> *J.G. Collins Ins. Agencies Ltd. V. Elsley* 2 S.C.R. 816, 928 (1978) (S.C.C.)

<sup>126</sup> *Kutten and Reams*, note 1 at 237.

<sup>127</sup> *Ward, Firms Forcing Employees to Repay Some Costs If They Quit Too Soon*, *Wall St. J.* (July, 1985) 29.

<sup>128</sup> *Philip Hunke, D.D.S. v. Wilcox*, 815 S.W.2d 855, 1991 Tex. Civ. App. Lexis 2172.

<sup>129</sup> Though the freedom itself is obviously important for preventing his exploitation by the employer who knows that the employee is "stuck" with him whether or not he will promote him, increase his salary, etc.

<sup>130</sup> *M. Trebilcock, supra* note 124, at 124.

Most of the legal restrictions are a matter of case law, developed by the courts for centuries. In some states the picture is further complicated by the existence of legislation. The prevailing legal test used by the courts to evaluate covenants not to compete is the reasonableness of the restriction test. The reasonableness of the restriction test is related to the legitimate interest of the employer, the hardship caused to the employee and the burden on the public. Each court weighs the various considerations according to its inclination, which hampers predictability and makes the work of practitioners extremely hard.