Settling Non-Compete Cases: Postponing Battle for Another Day?

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Settlement of lawsuits is almost universally considered a good thing. Among the many benefits is the notion that the conflict ends immediately and the parties can go on with their lives with the comfort of certainty. Right? Well, maybe. In non-compete cases, an employer might consider settling because it fears an unfavorable determination by the court that the geographical, temporal, or substantive scope of the non-compete agreement at issue may be overly broad. But some cases suggest that settlement might simply postpone this determination until another day. According to these courts, this is true because restrictive covenants in settlement agreements are subject to the same strict judicial scrutiny applied to employment agreement covenants.

The thought that a restrictive covenant set forth in a settlement agreement may be unenforceable may be hard to swallow. After all, a widely recognized incentive for settling cases is the opportunity to achieve finality while at the same time eliminating the risks inherently intertwined with litigation. For this reason, an employer who fears that its three-year, nationwide noncompete agreement may be overly broad may seek the seemingly safe harbor of settlement. It may seem like a good deal. From the employer's perspective, voluntarily reducing the scope of the covenant through settlement might seem akin to taking sleeves off a vest: if the restrictive covenant is overly broad, it is likely to be judicially modified or blue penciled to some virtually unpredictable extent; and settlement may bring side benefits such as certainty and mutual releases. But what happens if the former employee violates the settlement? At first glance, you might think that enforcement is a certainty because the employee consented to the reduced covenant in place of the previous covenant. Not so fast. Some courts see it differently.

For example, in Cranston Print Works Co. v. Pothier, 848 A.2d 213, 216 (R.I. 2004), the Rhode Island Supreme Court "noted that these covenants not to compete were unusual because they were part of a settlement agreement, rather than an employment contract, a contract for the sale of a business, or a partnership agreement." After finding that the trial court had interpreted the restrictive covenants in the settlement agreement incorrectly, it remanded the case for further consideration with instructions that the court "should uphold [the restrictive covenants] only to the extent they are necessary to protect the promisee's legitimate interests." Id. at 220.

A similar result can be found in the Texas Supreme Court's opinion in Justin Belt Co. v. Yost, 502 S.W.2d 681 (Tex. 1973). In Yost, the court observed that the "non-competition covenant at issue was ancillary to an agreement that settled the dispute between Justin and his former employees and accomplished a termination of the pending litigation." Id. at 684. Noting that the covenant at issue was not ancillary to an employment agreement, the Court stated that it nonetheless "was ancillary to an agreement highly favored by the courts." Id. Nonetheless, the Court went on to uphold the trial court's decision to modify the overly broad restraints set forth in the settlement agreement because they were unreasonable as written. Id. at 686.

Yet another court has explained that strict judicial scrutiny of a covenant in a settlement agreement may be necessary based on the relative bargaining power of the parties. Ken Manufacturing Corp. v. Sant, 355 S.E.2d 437, 444 (Ga. App. 1987). The Sant court explained: "If it appears that [the employee's] bargaining capacity was not significantly greater than that of a mere employee, then the covenant should be treated like a covenant ancillary to an employment contract," and subjected to strict judicial scrutiny. Id. See also Herndon, Jr. v. The Eli Witt Co., 420 So.2d 920, 923 (Fla. Ct. App. 1982) ("this Court is willing to subject the restraint imposed by the settlement agreement to a 'reasonable standard test'").

Lessons to be learned

The above-cited cases do not mean that employers should refrain from settling non-compete cases. But there are some lessons to be learned:

First and foremost, there is no substitution for restrictive covenants that follow the law. Include reasonable restrictions in settlement agreements that comport with applicable law, and specifically lay out the reasons that the covenants are necessary to protect legitimate business interests.

Second, be sure to include additional covenants that usually are not subject to strict scrutiny, such as confidentiality, non-use, and non-disclosure obligations. These covenants should be contained in individual paragraphs so that a court, if it chooses, can easily sever offending paragraphs.

Third, memorialize your settlement agreement by way of consent decree. If possible, include within the decree the parties' agreement, and the court's specific finding, that the restrictions in the settlement agreement are reasonable and necessary to protect the employer's legitimate interests (such as customer relationships, or confidential/trade secret information).

Fourth, require the employee to agree to a stipulated permanent injunction that tracks the language of the restrictive covenant included in the settlement agreement. Employees may be tempted to violate settlement agreements, but violating a court order raises the possibility of civil and/or criminal contempt, which in turn may act as a deterrent.

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