



Restrictive covenants in the US: navigating the quagmire of enforceability

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Post-employment restrictive covenants in the context of employment relationships have long posed challenges for employers. Both the nature of the agreement and the context in which it is entered into impact the enforceability of restrictive covenants. The lack of a unified or “national” body of law on restrictive covenants within the US further complicates the issue. For example, in some states, restrictive covenants are governed by the common law of contracts, and generally will be enforced if they are “reasonable” under the circumstances. Yet even the concept of what is “reasonable” varies from state to state. Other states have enacted statutes specifically governing restrictive covenants, often imposing strict requirements on the enforcement of the covenants and, in some cases, virtually prohibiting them. Ultimately, the enforceability of any restrictive covenant will depend on which state’s law applies, which in turn may depend on where the dispute is litigated.

OVERVIEW OF RESTRICTIVE COVENANTS IN THE US

Restrictive covenants are commonly used by employers to protect their valuable business interests, including:

- Trade secrets.
- Confidential information.
- Customer goodwill.
- The training and investment in their talent pool.

Post-employment covenants can vary significantly in scope, ranging from the most restrictive pure non-competition agreements to garden leave provisions, non-solicitation covenants and simple confidentiality agreements.

Non-competition agreements

Non-competition agreements (the most restrictive of the covenants) prohibit the departing employee from engaging in, or performing services for, any other competing businesses (often defined by product type, geography and/or market) for a certain restricted period of time. Although generally enforceable in most jurisdictions, non-competes are disfavoured by the courts for imposing restraints on trade and thwarting employee mobility. The more the covenant is seen as preventing the departing employees from earning a livelihood within their field of expertise, the less likely it is to be enforced. On the other hand, the courts are more willing to hold an employee to the terms of a restrictive covenant where:

- An employee is paid severance for much or all of the restricted period.
- A senior level executive received significant compensation for agreeing to the covenant.

Garden leave provisions

Similar in impact to pure non-competes, garden leave provisions are a relatively recent import to the US from the UK and other European countries. Most commonly included in a written employment agreement, garden leave provisions require the departing employees to provide mandatory notice of resignation (typically between three and six months). The employees remain employed throughout the notice period, and receive full salary and other benefits, but after giving notice, are not required to perform any further (or only very limited) services for the company. Because the employees remain employed by the company, they continue to owe a duty of loyalty to the employer and are not free to work for anyone else.

While garden leave provisions are becoming increasingly common in the US (especially in the financial services industry), there is relatively little case law testing their enforceability (perhaps because they are infrequently challenged, and honoured by many new employers). The few cases which have specifically addressed these provisions have reached conflicting conclusions. For example, in *Bear Stearns & Co v McCarron*, Case No. 08-0979-BLS (Mass. Super. Ct. Suffolk Co. 2008), a Massachusetts state court refused to enforce a 90-day garden leave provision against three highly compensated brokers which was “buried” in the company’s compensation plan documents. The court reasoned that the employees should have had an opportunity specifically to agree to the provision, and refused to enforce it because it had the effect of depriving clients of their brokers of choice during the garden leave period. A federal court in Massachusetts reached a similar result in *Bear Stearns & Co v Sharon*, 550 F.Supp.2d 174 (D. Mass. 2008), and refused to enforce a 90-day mandatory notice (garden leave) provision contained in a memorandum signed by the departing managing director. The court reasoned that enforcing the notice provision had the effect of continuing an “at will” employment relationship against the managing director’s will.

Conversely, in *Bear Stearns & Co v Arnone*, Case No. 103187 (Sup. Ct. N.Y. Co. 2008), a New York state court enforced a garden leave provision against a departing broker who contacted her clients during the garden leave period, informing them that she could be reached at her new employer following the garden leave period. The court prohibited her from any further communications with those clients.

Because garden leave serves the same function as a paid for non-compete period, these provisions will be strictly scrutinised by the courts. Employers should use caution in importing garden leave provisions from abroad without giving due consideration to the usual factors which affect the enforceability of restrictive covenants.



Non-solicitation of customers/prospective customers

Less restrictive than non-compete or garden leave provisions are non-solicitation provisions which provide the employer with direct protection for the goodwill developed with the employer's clients. Courts are more receptive to non-solicitation covenants than non-compete agreements because they do not impede the future employment of the departing employee, but only limit their activities for a period of time. Many courts will not enforce non-solicitation agreements with respect to mere "prospective" clients, absent evidence of the employee's involvement in a specific pitch for business to that prospect or an exchange of confidential information.

Non-solicitation clauses sometimes seek to bar the employee not only from soliciting business, but from accepting business from the company's clients for a period of time, whether or not the employee engages in any active solicitation. While there is no *per se* ban on these provisions, courts are hesitant to enforce these limitations because they are seen as harmful to the general public (that is, they limit consumers from their choice of service providers or suppliers). While courts in New York and Florida have enforced such restrictions, courts in South Carolina, Georgia and elsewhere routinely strike these restrictions as overly broad and unenforceable. Moreover, for stockbrokers and other financial services employees who are governed by the Financial Industry Regulatory Authority (FINRA, formerly NASD), FINRA rules specifically prohibit any limitation on brokers' ability to accept business from a client who seeks their services.

Non-solicitation provisions are commonly coupled with non-compete restrictions as a less restrictive alternative that will still provide the company with significant protections in the event the non-compete clause is deemed unenforceable. To ensure enforcement, these agreements should contain severability provisions, specifically stating that if one clause is found to be unenforceable, it does not affect the enforceability of the remaining provisions.

Non-solicitation of employees/anti-raiding provisions

Also commonly included in restrictive covenants or employment agreements are prohibitions against soliciting the company's employees. These provisions are routinely enforced to protect the company's investment in the training and development of its personnel, even in those jurisdictions which are otherwise hostile to restrictive covenants.

Confidentiality agreements

Finally, many employers require their employees at all levels to sign some form of a confidentiality or proprietary rights agreement. Throughout the US, documents and information which rise to the level of "trade secrets" are generally protected under the common law or, in a vast majority of states, by a version of the Uniform Trade Secrets Act (UTSA). Confidentiality agreements allow employers to provide for additional protection of information which may in fact be confidential and important to the employer's business, but which may not qualify as a trade secret under the applicable law. Confidentiality agreements are generally enforceable throughout the US, even in those jurisdictions which restrict the enforcement of non-competition and non-solicitation agreements.

KEY ISSUES DETERMINING ENFORCEABILITY ACROSS JURISDICTIONS

As a result of the lack of any national law or generally applicable standard governing the enforceability of restrictive covenants, parties go to great lengths to dictate not only what law will apply, but where any dispute about the covenants will be litigated. The following demonstrates the breadth and disparity of answers given by different courts to the same questions concerning the enforcement of restrictive covenants, and how the resolution of the choice of law issue may ultimately determine whether a covenant will be enforced.

Are you in a covenant-hostile state (the "California" problem)?

Although most jurisdictions will enforce reasonable post-employment restrictive covenants in the context of the employment relationship, a few states severely limit (and in some cases virtually eliminate) an employer's ability to enforce non-competition and non-solicitation covenants against its former employees. Employers with operations or employees in these states may want to take steps to apply the law of a state with more favourable laws, provided that there is a reasonable basis for doing so (for example, the company is headquartered, has substantial operations or is incorporated elsewhere).

The harshest and most well-known covenant-hostile state is California. By statute and as matter of the state's public policy, California prohibits nearly all non-competition covenants, subject to very limited exceptions (for example, the sale of a business, including asset purchases). Further, employers cannot evade these restrictions by, for example, formulating a covenant that does not absolutely bar an employee from working for a competitor but imposes some penalty for doing so. This prohibition also extends to non-solicitation of customer covenants, as these covenants restrain employees from engaging in their chosen profession or trade (see *Edwards v Arthur Andersen LLP*, 44 Cal. 4th 937, 946 (2008)).

In contrast, appropriately tailored non-solicitation of co-worker (anti-raiding) covenants are enforceable in California. Confidentiality agreements are also generally enforceable under California law. However, broad "no-hire" provisions, where an employee agrees not to hire former co-workers, regardless of whether the employee solicited them, unduly restrain worker mobility and are generally unenforceable in California (*VL Sys, Inc v Unisen, Inc*, 152 Cal. App. 4th 708, 710, 718 (2007)).

Under Oklahoma law, any agreement which prohibits an employee from engaging in the same business as that conducted by the former employer, or in a similar business as that conducted by the former employer, is "void and unenforceable" (20 *Title O.S.* 2001, § 219A). However, because Oklahoma law also prohibits a former employee from directly soliciting "the sale of goods or services ... from the established customers of the former employer", even without a non-solicitation provision, an Oklahoma employer has legal protection for its established customer goodwill.

North Dakota is the only other state which essentially prohibits the enforcement of non-compete covenants by statute (*North Dakota Century Code*, § 9-08-06). The law includes limited exceptions in the case of the sale of a business or the dissolution of a partnership.



Although not as restrictive as California or North Dakota, Colorado similarly imposes significant limitations on the circumstances under which restrictive covenants will be enforced. In Colorado, non-compete covenants are prohibited unless they are related to (*Colorado Revised Statute, § 8-2-113*):

- The purchase or sale of a business.
- The protection of trade secrets.
- The recovery of training expenses for persons employed for less than two years.
- Executive or management employees or their professional staff.

Until the passage of the Georgia Restrictive Covenants Act in May 2011, Georgia had a strong public policy against restraints on trade, which was used as the basis for holding many non-competition agreements unenforceable. The new legislation represents a dramatic shift in the state's former stance on restrictive covenants. Namely, the Act:

- Provides for judicial modification of an otherwise overly broad covenant to make it enforceable.
- Allows the courts to evaluate non-solicitation covenants and non-compete covenants separately, and to enforce one without regard to the enforceability of the other.
- Enhances the enforceability of non-disclosure provisions by defining "confidential information" and eliminating the need for a time limit for non-trade secret confidential information.

However, because the Act only applies to those agreements entered into after the effective date of the law, employers with any agreements which predate 11 May 2011 must evaluate the enforceability of the agreements under Georgia's old (and more restrictive) regime.

In Massachusetts, recent cases have confirmed that material alterations to the employment relationship, such as compensation (which includes salary and other payment or benefits guaranteed as a result of employment), may render pre-existing non-competes unenforceable. Massachusetts also has proposed legislation (not yet passed at the time of writing) which would serve to further restrict the enforceability of restrictive covenants in that state (though these restrictions would not reach the level of the California or North Dakota prohibitions).

Other quirky restrictions and requirements are peppered throughout state statutes. For example, in Texas, restrictive covenants will only be enforced if they are entered into "ancillary to" or as "part of" an otherwise enforceable agreement between the parties (*Tex. Bus. & Com. Code, § 15.50 and § 15.52*). However, recent case law has relaxed the interpretation of this requirement, making it somewhat easier for employers to enforce non-competes in that state. Louisiana will only enforce covenants which are limited in scope to those locations where the employer conducts business and which specify, by name, the parish or municipality covered by the agreement. Any choice of law or forum selection provision will be void and unenforceable unless the clause is expressly, knowingly, and voluntarily agreed to and ratified by the employee after the occurrence of the incident which is the subject of the action (*Louisiana Rev Stat, § 23.921*).

In Oregon, non-competes are voidable unless either:

- The employer informs the employee, at least two weeks before starting employment, that a non-compete is required as a condition of employment and provides the employee with the agreement.
- The agreement is entered into in connection with a bona fide advancement during employment.

The employee must be an executive, administrative or professional employee exempt from the overtime requirements, and have access to trade secrets or competitively sensitive information. Restrictions longer than two years in duration are prohibited. Similarly, since 12 July 2012 New Hampshire has required employers to disclose in writing non-competes and anti-piracy agreements to employees or potential employees prior to making an offer of employment or offering a change in an employee's job classification. Any agreement which does not comply with this requirement is void and unenforceable.

Is the covenant reasonable?

Apart from the "covenant hostile state" issue discussed above, the majority of jurisdictions within the US (either by statute or case law) will enforce restrictive covenants to the extent they are "reasonable" under the circumstances. Generally, a restrictive covenant will be found reasonable only if:

- It is no greater than is required for the protection of the employer's legitimate business interest.
- It does not impose an undue hardship on the employee.
- It is not injurious to the public (*Restatement [Second] of Contracts, § 188*; see, for example, *BDO Seidman v Hirschberg*, 93 N.Y.2d 382 (1999)).

While the statement of the law seems clear and straightforward, the determination of what is "reasonable" and what constitutes a "protectable interest" is resolved on a case-by-case, state-by-state basis, which can create inconsistent results. Nonetheless, while there is not a single test that can be applied to determine how "reasonableness" is interpreted, some guidelines can be derived from a view across jurisdictions.

Does the covenant contain a reasonable temporal restriction?

Temporal restrictions of up to one year are rarely stricken on the basis that they are *per se* unreasonable. In many jurisdictions, restrictions up to two years are routinely enforced, if the restrictive covenant is otherwise reasonable in scope under the circumstances. In other jurisdictions, such as New York and Michigan, restrictions up to three years have been commonly upheld.

Some jurisdictions define what constitutes a "reasonable" time period by statute. For example, in Missouri, covenants of up to one year following the termination of employment are conclusively presumed to be reasonable. In Florida, restrictions of more than two years are "presumptively unreasonable", and conversely, restrictions of less than six months are "presumptively reasonable", leaving a grey area for those that fall in between. Similarly, under the new Georgia statute, a two-year restriction is presumptively valid. Other states, such as Louisiana, contain flat out prohibitions on restrictions of more than two years in duration.

Recently, technology and the internet have begun to influence how courts evaluate the reasonableness of a temporal restriction. Given the rapid pace of information transfer within technology-driven



industries, and the pace at which even the most confidential information loses its value (or ceases to be confidential), restrictions between one and two years have been struck down as overly broad and unreasonable in the context of certain businesses.

Other factors to be considered in determining whether a temporal restriction is reasonable include:

- The length of time an employee has been employed at the time of termination.
- The nature and amount of consideration provided for the covenant.
- The circumstances of the employee's departure (whether voluntary or involuntary).
- The degree to which the employee has had access to high level strategic and proprietary information.
- The business cycle of the industry.

For example, a two-year restriction on a commercial insurance broker, where client relationships are formed over months, even years, and the business cycle of renewals is every two to three years, is more likely to be upheld than a two-year restriction on a sales representative who sells by cold-calling and does not rely on repeat or renewal business.

Some courts will allow the parties to agree that the time period of the restriction will be extended by the amount of time the employee has been in breach of the provision. A New York appellate court recently enforced such a provision (*Delta Enterprise Corp v Cohen* (1st Dep't 2012)). These clauses are recommended to ensure that the covenant does not become moot before final adjudication of the dispute.

Does the covenant contain a reasonable geographic restriction?

Historically, covenants lacking any geographic restriction were viewed as overly broad, unreasonable, and therefore unenforceable. For the same reason, restrictive covenants which were national or international in scope were often struck down on the grounds that they were broader than necessary to protect any legitimate business interest.

With the proliferation of global and internet-based commerce, these geographic boundaries have become virtually meaningless. As one court aptly noted, "in this Information Age, a *per se* rule against broad geographic restrictions would seem hopelessly antiquated..." (*Victualic Co v Tiernan*, 499 F.3d 227 (3d Cir. 2007)). Courts are increasingly willing to find that covenants with very broad geographic boundaries, or with no boundaries at all, are reasonable, particularly to the extent that they only restrict conduct with respect to an employer's specific customers or clients. For example, as more business is conducted over the phone lines or the internet, and more employees "telecommute" or work remotely, physical geographic restrictions do little to protect the employer, where the employee can conduct their business from anywhere in the world where there is a telephone or a computer.

Despite the globalisation of the economy and an increase in internet-based business, certain US jurisdictions by statute still require more geographic specificity. For example, in Louisiana, restrictive covenants must be limited to those specific parishes (similar to counties) where the employer conducts business, and must identify those parishes by name. South Dakota similarly requires the parties to specify the county or municipality in which the covenant

applies. Georgia courts will not enforce restrictive covenants beyond the geographic area in which the employee was actually working. Texas similarly requires the scope of the geographic restriction to be no broader than the area in which the employee worked.

Is the covenant designed to protect a legitimate business interest?

Most jurisdictions recognise that trade secrets are a legitimate business interest worthy of protection by restrictive covenants. 45 states have adopted a version of the Uniform Trade Secrets Act to codify this protection and provide some uniformity to the definition of a trade secret.

Similarly, most states will recognise the need to protect customer goodwill developed over time. However, depending on the nature of the business (including the cycle of relationship building, the ease with which clients and prospects can be identified, and the nature of confidential information shared between the employer and its clients), some states have limited the protection of these client relationships. For example, in New York, the courts will not extend anti-competitive restrictions to the employer's clients with whom the employee did not develop any relationship, finding these restrictions to be broader than necessary to protect the employer's legitimate business interests. Similarly, the courts have declared it unreasonable to extend restrictive covenants to the "personal clients" of an employee whose business came to the employer solely "as a result of the employee's own independent recruitment efforts", which the employer did not subsidise or financially support (*BDO Seidman, supra*). On the other hand, California finds non-solicitation of client relationships to be similar in nature to non-competes, and refuses to enforce them.

Courts generally recognise an employer's legitimate interest in protecting its investment in its workforce. To that end, covenants restricting departing employees from soliciting their former co-workers are routinely enforced, even in California. However, the courts look more harshly on "no hire" restrictions which apply regardless of the solicitation efforts (or lack of them) by departing employees.

Was there sufficient consideration for the covenant?

As with any contract, restrictive covenants require adequate consideration to be enforceable. Not surprisingly, what constitutes adequate consideration for a restrictive covenant varies considerably from state to state.

In the US, absent an agreement to the contrary, most employees are hired on an "at will" basis, which means that their employment can be terminated at any time, with or without notice, and with or without cause. As a result, a majority of states hold that continued employment of an "at will" employee is sufficient consideration for a restrictive covenant. In other words, by refraining from dismissing the employee, the employer is giving up a legal right, and the employee is enjoying a benefit (of continued employment) to which he or she is not otherwise legally entitled. However, because enforcement is determined on a case-by-case basis, no doubt courts would frown on (and likely refuse to enforce) a covenant which was entered into only days or weeks prior to the involuntary termination of employment by the employer if continued at will employment were the only consideration for the covenant.

Conversely, several states expressly (either by statute or case law) provide that mere continued employment is insufficient consideration. These states include Minnesota, North Carolina, South Carolina, and Oregon. By statute, Pennsylvania and Texas expressly



require that restrictive covenants are only enforceable if they are entered into coincident with, or ancillary to, another enforceable agreement (most commonly an employment contract).

In the event the parties do not enter into an agreement at the outset of the employment relationship, employers often seek to impose restrictive covenants in connection with a promotion, raise, bonus, or a grant of stock options or equity. As long as the covenant is otherwise enforceable, these actions generally will constitute sufficient consideration. Note, however, in a recent case from North Carolina, the court found that a grant of restricted stock which vested over a five-year period commencing three years from the grant date, and which would be forfeited on termination of employment, did not constitute sufficient consideration. The court held that because employment could be terminated the day after the agreement had been signed, the consideration offered for it was illusory (*see MSC Industrial Direct Co v Steele* (N.C. 2009)).

For this reason, when seeking to impose restrictive covenants on existing employees, it is generally recommended that some other consideration (in addition to continued at will employment) be offered, even if operating under the law of a jurisdiction which would otherwise find at will employment to be sufficient.

“Reformation”, “blue pencil” or “all or nothing”: will the court modify an unenforceable covenant?

In most jurisdictions, courts will use their judicial discretion to modify an overly broad covenant. For example, if the agreement restricts competition in a geographic scope which is broader than where the company conducts business, and therefore broader than necessary to protect the company's legitimate business interests, the courts will enforce the restriction but limit enforcement to the area of the company's business operations. Similarly, if the covenant extends for a period of time which is too long, the courts will often reduce the restricted period and enforce the covenant.

In these reformation states, employers may be tempted to include boilerplate, overly broad covenants without considering what is really needed to protect their interests, using the rationale that the courts will limit the scope of the covenants if they are too broad. However, in many jurisdictions, including New York, the courts will only allow reformation in the absence of overreaching, coerciveness of dominant bargaining power or other anti-competitive misconduct, and where the employer has in good faith tried to reasonably protect a legitimate business interest (*see BDO Seidman v Hirschberg, supra*). As a result, employers are well-advised to ensure that there is a legitimate business rationale for the scope of the restrictions being imposed.

In a limited number of jurisdictions, the courts will only modify overly broad agreements if the desired result can be accomplished by “blue pencilling” the agreement (literally, crossing out certain grammatically independent words or phrases, without adding or rewriting any others). In states which adopt this more restrictive approach (for example, Arizona, Colorado, Connecticut, North Carolina, Indiana, Ohio, and Missouri), additional care is warranted in drafting covenants.

The blue pencil approach encourages the use of “step down” provisions which allow the court simply to strike the offending, overly broad provisions, yet leave the language of the more tailored restrictions intact. A sample step down provision could include the following:

- Employee is prohibited for two years from working for any competing business worldwide.

- Employee is prohibited for two years from soliciting the business of any company client wherever located.
- Employee is prohibited for two years from soliciting the business of any company client which the employee serviced or solicited within New York City.
- Employee is prohibited for one year from soliciting the business of any company client which the employee serviced or solicited within New York City.

In the event any of the first three provisions are deemed overbroad, the court could “blue pencil” or strike out these severable provisions, leaving the last restriction intact and enforceable. However, step down provisions create ambiguities for departing employees, who cannot accurately gauge the scope of the restrictions to which they are required to comply, and they can be challenged on this ground.

Finally, a minority of states (for example, Arkansas, Georgia (prior to the new legislation), Nebraska, Wisconsin and Virginia) take an “all or nothing” approach with respect to restrictive covenants in the employment context. If the covenant is unreasonable, overly broad or non-compliant with a statutory requirement in any way, the covenant will be struck down in its entirety. Special care must be given to drafting covenants when there is a possibility that the law of any of these jurisdictions could apply.

Was the employee involuntarily dismissed?

While most states will enforce restrictive covenants against departing employees regardless of the reason for the termination of employment (especially if the agreement expressly so provides), some states, whether as a blanket rule or as part of their consideration of the facts and circumstances of the case, refuse to enforce restrictive covenants against employees who were involuntarily dismissed, particularly if the dismissal was without cause. For example, in Washington, by statute, restrictive covenants will not be enforced against employees who were dismissed without just cause or were laid off (made redundant) by the employer. Similarly, in Montana, the state Supreme Court has held that restrictive covenants are unenforceable against discharged employees, because an employer lacks a legitimate interest in the covenant when it ends the employment relationship.

In New York, some cases have interpreted the law as establishing a rule against enforcement in the cases of involuntary termination (*see, for example, SIFCO Industries, Inc v Advanced Plating Technologies, Inc*, 867 F.Supp 155, 158 (S.D.N.Y. 1994)). Other cases have only refused to enforce restrictive covenants on this basis where the termination was without cause (*see, for example; In re UFG International, Inc*, 225 B.R. 51, 55 (S.D.N.Y. 1998)). In most jurisdictions, the manner of the termination of employment will at least be a factor considered by the court in considering whether the covenant is reasonable under the circumstances.

LOCATION, LOCATION, LOCATION: DETERMINING WHICH STATE'S LAW APPLIES

As shown above, the choice of law can dramatically influence the outcome in any action to enforce restrictive covenants. While employers can attempt to dictate the applicable law by agreement, choice of law provisions are not consistently enforced across states. Ultimately, the determination of which state's law applies may depend on where the dispute is heard. Therefore, it remains in the employer's interest to dictate in the contract (to the extent



this is feasible) not only the applicable choice of law but also the venue in which any dispute will be litigated. A brief analysis of the relevant choice of law principles is discussed below.

Which state's law applies in the absence of a choice of law provision?

Most states (including New York, Delaware, Colorado, Connecticut, Alaska, Arizona, California, Idaho, Illinois, Iowa, Maine, Mississippi, Missouri, Montana, Nebraska, South Dakota, Ohio, Texas, Utah, Vermont and Washington) have adopted some version of the Second Restatement of the Conflict of Laws (the Restatement). In the absence of a choice of law provision, the Restatement applies a "significant relationship" test, which takes into account:

- The place of contracting.
- The place of negotiation of the contract.
- The place of performance.
- The location of the subject matter of the contract.
- The domicile, residence, nationality, place of incorporation and place of business of the parties.

The law of the state with the most "significant relationship" to the dispute will be applied. If the place of negotiating the contract and the place of performance are in the same state, the law of that state will usually apply.

Will the courts enforce choice of law provisions?

Most restrictive covenant and employment agreements contain a choice of law provision. Typically, this is either the state of the employer's primary place of business, or the state in which the employee lives and/or works (if they are not one and the same). In those states following the Restatement, the courts generally will enforce the parties' choice of law, unless:

- The chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties' choice.
- The application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of the Restatement, otherwise (absent a choice of law provision) would be the state of the applicable law.

Disputes concerning choice of law provisions in the context of restrictive covenants frequently arise when any of the parties lives or works in California (or one of the other "covenant hostile" states). It is undisputed that California has a fundamental public policy against the enforcement of restrictive covenants. Therefore, any attempt to apply the law of another state to an employee who lives or works in California will be met with efforts to invalidate the covenant on public policy grounds, regardless of any choice of law provision in the agreement seeking to apply the law of another state. Often, the employee is successful.

For example, in *Application Group Inc. v Hunter Group, Inc.*, 61 Cal.App.4th 881 (1998), a California court refused to enforce a Maryland choice of law provision, holding that the application of Maryland law would violate the fundamental public policy of California. The employee, a California resident, signed a covenant not to compete with her Maryland-based employer. The

agreement provided that it "was to be governed by and construed in accordance with the laws of the State of Maryland".

The employee went to work for a competitor in California. The employee (and her new employer) pre-emptively filed suit in California, seeking a declaration that California law, and not Maryland law, applied to her covenant not to compete with her former employer. The California Court of Appeals held that California's prohibition on non-competition agreements reflects fundamental California public policy, and that California had a materially greater interest in the application of its laws to the dispute than did Maryland. Accordingly, the California court refused to enforce the Maryland choice of law provision.

Venue and the race to the courthouse

Critically, had the *Application Group* case been first-filed by the employer in Maryland, the result might have been different, as the Maryland court would have been more likely to enforce the Maryland choice of law provision. *ACS Consultant Co, Inc v Williams*, 2006 WL 897559 (E.D. Mich. 2006) is just such an example of an out of state employer enforcing a non-compete provision against a California worker. Several California-based employees of ACS signed non-compete agreements with both Michigan choice of law and forum selection clauses. One of the employees subsequently went to work for a California-based competitor. The employer filed suit in Michigan seeking to enforce the non-compete provision (among others). The Michigan court found that the provision was enforceable under Michigan law and barred the employee from engaging in competitive activity for the term of the agreement.

What would have happened in the *ACS Consultant* case if the employee had filed an action for declaratory relief in California, before the employer could bring suit in Michigan? Absent a forum selection clause, no doubt the result would have been the same as in *Application Group*, with the California court refusing to apply Michigan law. But the forum selection clause in the *ACS Consultant* agreement in all likelihood would have caused the California court to send the case back to Michigan. Even in situations when courts will not enforce choice of law provisions, most courts will enforce forum selection clauses and decline to hear a case, even if doing so would result in the application of a law which is contrary to their own state's public policy.

That is precisely what happened in *Swenson v T-Mobile USA, Inc.*, 415 F.Supp.2d 1101 (S.D. Cal. 2006), which involved a dispute between an employer and one of its employees, who was a California resident. The employer was incorporated in Delaware and headquartered in Washington. The employee entered into a one year non-compete agreement, which provided that it would be governed by Washington law and that the employee consented to jurisdiction and venue in Washington.

When the employee left to join a start-up company based in California, the employer filed suit in Washington to enforce the agreement, and the employee filed a declaratory relief action in California seeking to invalidate the agreement. The employee argued that the forum selection clause would result in application of Washington law, which violated California public policy. The California court held that enforcement of the forum selection clause itself did not contravene public policy, and that the employee was free to make the argument that California law should apply to the Washington court. Accordingly, the court dismissed the employee's California suit. Again, without the forum selection clause, the



California court probably would have reached the same result as in *Application Group*, and refused to enforce the Washington choice of law provision on its own turf.

PRACTICAL CONSIDERATIONS FOR THE MULTI-JURISDICTIONAL EMPLOYER

For multi-jurisdictional employers, the first step is to determine the scope of operations within the US:

- Will the company have operations in any covenant hostile states, such as California or Colorado?
- Will any of its employees live or regularly travel to those covenant hostile states?
- Does the company have a central place of business within in the US?
- Do the employees who will be subject to restrictive covenants have any significant connection to that home state?

Depending on the answers to these questions, the employer then needs to decide whether it makes sense to adopt a single form agreement for all its employees (at least for all employees at a given level). If there is a reasonable basis for imposing a favourable choice of law provision, this is often the preferred approach, and it provides greater uniformity among similarly situated employees. Employers can consider enhancing the employee's ties to the selected state (for example, with periodic meetings at the home office) to increase the likelihood that the selected choice of law will be applied.

Even employers without current operations in California should select the law of a favourable jurisdiction with a reasonable connection to its operations, coupled with a forum selection clause in which the parties agree not only to the location of the dispute, but also consent to personal jurisdiction in that forum, and waive any objection to the forum based on inconvenience to any of the parties (or *forum non conveniens*). As demonstrated by the cases above, in the event an employee leaves to work for a competitor in California, or some other state with less favourable laws, the inclusion of a forum selection clause may mean the difference between having an enforceable covenant and being left without any protection against competition at all.

For an employer based in California, or with substantial operations there, imposing restrictive covenants on its employees working in California is more difficult. If the employer is incorporated in Delaware (as are many US companies), a Delaware choice of law provision may offer some hope. A Delaware statute specifically authorises the parties to a contract involving US\$100,000 or more to include a Delaware choice of law provision in their contracts, and states that the inclusion of such written provisions in an agreement "shall conclusively be presumed to be a significant, material and reasonable relationship with this state and shall be enforced whether or not there are other relationships with this state" (6 *Delaware Code* § 2708). Coupled with a forum selection clause providing that the dispute be litigated in Delaware, the California-based employer which is incorporated in Delaware may be able to obtain some degree of protection.

If the company is incorporated and based in California, unless there is some reasonable basis for selecting the law of another state to govern the dispute, those employers should consider

adopting multiple agreements for their employees. It can then seek to impose more stringent provisions on those employees located outside the state of California, again coupled with choice of law, forum selection and consent to jurisdiction provisions. For those employees in California, the agreement should remain silent as to the choice of law. In that way, if the employee leaves to compete in another state, at least there will be some basis for arguing that the law of another state should apply.

Regardless of the applicable law or jurisdiction, employers should strive to adopt carefully crafted covenants, narrowly tailored to protect the employer's specific business interests, and resist the temptation to draft the broadest possible restrictions. Employers should not count on the courts to reform overly broad covenants, even if they are in a blue pencil or reformation state.

Ultimately, the enforcement of restrictive covenants in the US is at best unpredictable, bordering on the capricious. While a favourable choice of law provision, even when coupled with a mandatory and exclusive forum selection clause, may not guarantee the enforcement of restrictive covenants in all situations, it will enhance the employer's ability to control the applicable law, and where the dispute will be heard. And that may make all the difference.

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- Obtained summary judgment and prevailed on appeal to New York Appellate Division in non-compete action against departing employee and new employer.
- Speaker, New York State Bar Association Annual Meeting, Labor and Employment Section, January 2011: "Restrictive Covenants – An Employer's Perspective".



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