Allowable Scope of Restrictive Covenants Remains Unclear After Recent Decision Declares Legitimate-Business-Interest Test Broad Enough to Encompass Other Protectable Interests

By Michael P. Tomlinson

December 20, 2010 – A little more than two months ago, in *Steam Sales Corp. v. Summers*, No. 2-10-0073, 2010 WL 2970375, *10 (2d Dist. Oct. 4, 2010), the Illinois Appellate Court of the Second District decided the first major restrictive covenant decision since the Fourth District issued its opinion in *Sunbelt Rentals, Inc. v. Ehlers*, 394 Ill. App. 3d 421, 432 (4th Dist. 2009). The *Sunbelt* Court rejected the legitimate-business-interest test and held that only the time and territory restrictions had to be reasonable for a restrictive covenant to be enforceable. *Id.* at 432. Ultimately, the *Steam Sales* Court did not have to decide whether it was *required* to apply a test other than the legitimate-business-interest test in determining whether a restrictive covenant was reasonable because it found the facts of that case satisfied the legitimate-business-interest test in any event. Although it did not need to decide whether to agree with the *Sunbelt* Court's analysis, the *Steam Sales* Court stated, "to the extent that *Sunbelt* can be interpreted to require analysis of *only* the time and territory aspects of a restraint, we note that the reasonableness of time and territory should still be evaluated *in relation to a protectable interest.*" *Id.* (internal citation omitted) (emphasis in original). As I recently wrote in analyzing the importance of the *Steam Sales* case, "[the case is] significant because it indicates that there may be cases in which the courts will evaluate whether protectable interests other than the already-recognized legitimate business interests can suffice to show the reasonableness of a restrictive covenant." *Employers and Their Attorneys Left Wanting More Guidance After First Major Post-Sunbelt Decision Regarding Reasonableness of Restrictive Covenants, available at* www.tomlinson-law.com/RestrictiveCovenantcases.aspx.

Earlier this month, in *Reliable Fire Equipment Company v. Arrendondo et al.*, No. 2-08-0646, 2010 WL 4967924 (2d Dist. Dec. 3, 2010),[1] the Second District squarely addressed the framework within which to analyze the reasonableness of a restrictive covenant's scope, though it did so through three separate opinions. The majority of justices agreed that the post-employment restrictive covenants at issue were not enforceable, but differed as to how to describe the test to be applied regarding whether their scope was reasonable. *Id.*

The lead opinion, written by Justice Zenoff, avoided rejecting the legitimate-business-interest test outright by finding that it was broad enough to encompass protectable interests other than only those involving a near-permanent relationship or potential misappropriation of confidential information. *Id.* at *21 ("[t]he legitimate-business-interest test need not be inflexible if broadly construed.") Specifically, the lead opinion stated the following:

[1] Also *available at* http://www.state.il.us/court/Opinions/AppellateCourt/2010/2ndDistrict/December/2080646.pdf. The opinion has not yet been released for publication in the permanent reporters and as such, remains subject to revision or withdrawal.

> However, in our view, those opinions like *Lifetec and Appelbaum*, which treat the two prongs of the legitimate-business-interest test as categorical pronouncements, may be unduly restrictive. Other criteria may exist that warrant protection under the law beyond those enumerated in the two traditional prongs of the legitimate-business-interest test. Yet, we find that no other interest has been established in the record beyond plaintiff's desire to shield itself from ordinary competition.

Id. at *22.

As such, although the lead opinion applied the legitimate-business-interest test and appeared to retain it in name, it also seemed to clarify or broaden its application or scope.[2] Further, in concluding its analysis of the scope of the restrictive covenants at issue and finding them unenforceable, the lead opinion stated, "[b]ecause plaintiff cannot demonstrate a protectable interest, *that is, one over and above the suppression of ordinary competition*, to justify a restraint of trade, it is unnecessary to proceed to a time-and-territory analysis." *Id.* at *30 (emphasis added). Thus, the the overriding principle in determining whether the scope of a restrictive covenant is too broad remains whether it seeks to do something other than suppress "ordinary competition." If it does, then under the approach espoused by the lead opinion in *Reliable Fire*, the interest it seeks to protect may be upheld based on an analysis of a flexibly applied and broadly construed legitimate-business-interest test, which may encompass scenarios outside of those found in the often-cited two prongs of the legitimate-business-interest test.

Both the special concurrence written by Justice Hudson and the dissent written by Justice O'Malley took issue with Justice Zenoff's approach in applying what was, at least in theory, a broader legitimate-business-interest test. Both opinions favored applying essentially a totality-of-the-circumstances approach instead of engaging in a "*post hoc* revision of the test." *See id.* at *33 (Hudson, J., specially concurring); *id.* at *34 (O'Malley, J. dissenting). As the special concurrence pointed out, the lead opinion arrived at its flexible application of the legitimate-business-interest test by seizing on the wording in a minority of cases that applied the test, which described its two prongs as the two situations that "generally" would satisfy the test. *Id.* at *32 (Hudson, J., specially concurring). However, very few courts actually apply the legitimate-business-interest tests so flexibly. *Id.* at *32 (Hudson, J., specially concurring). In fact, as the special concurrence stated, the majority of courts view the two often-cited prongs of the

[2] Curiously, after finding that the legitimate-business-interest test was flexible enough to account for protectable interests other than those encompassed by the two prongs of the legitimate-business-interest test, the lead opinion proceeded to apply the two "traditional" prongs of the legitimate-business-interest test to invalidate the restrictive covenants at issue. *Id.* at *27-*31. Perhaps it was because it could not perceive of other factors beyond those traditionally discussed in connection with the legitimate-business-interest test based on the evidence presented in *Reliable Fire*. Indeed, the Court clearly held that the plaintiff's evidence did not demonstrate a protectable interest beyond the suppression of ordinary competition. *Id.* at *30.

legitimate-business-interest as "a sine qua non for the enforcement of a covenant not to compete." *Id.* (also stating that "[f]ar more often than not, the legitimate-business-interest test has been presented as representing the only two circumstances under which an employer can enforce a covenant not to compete.").

Regardless of how the analytical framework for testing the scope of a restrictive covenant is described, one thing appears clear based on the *Reliable Fire* decision (and the *Steam Sales* dicta): at least as far as the justices in the Second District are concerned, satisfying the two often-cited prongs of the legitimate-business-interest test is no longer the exclusive means for businesses to demonstrate a protectable interest. *See, e.g., id.* at *33 (Hudson, J., specially concurring) ("It would appear, however, that a careful reading of the three opinions in this case makes clear that this district is no longer committed to a strict application of the two restrictive prongs of the legitimate-business-interest test."). However, one must keep in mind that Illinois has a unified appellate court, meaning the Second District's decision is not binding on the other districts. *See id.* at *45 (O'Malley, J. dissenting). Thus, the appellate court is now fractured severely regarding how to analyze whether a restrictive covenant is reasonable in scope. Indeed, recall that the last pronouncement from the Fourth District in *Sunbelt* rejected the need to analyze whether a protectable interest needed to be demonstrated at all, reasoning that parties should be able to contract to protect whatever interests they want. *Id.* at *25. The issue therefore appears to be ripe for the Illinois Supreme Court to step in and provide some much needed guidance. Perhaps *Reliable Fire* will be the case that provides that guidance.

Assuming that some protectable interest will have to be demonstrated, what other protectable interests will qualify?[3] In all likelihood, the answer ultimately will be that it will depend on the facts and circumstances of the case, including the nature of the business at issue. The lead opinion in *Reliable Fire* indicated that "[p]laintiffs engaged in businesses that engender customer loyalty, as with unique products or personal services, tend to fare better under the legitimate-business-interest test than do businesses with customers who use many different suppliers simultaneously to meet their needs." *Id.* at *21 ("However, no fast rules apply in regard to outcome . . . ."). It also stated that "sales (as opposed to professional services) will generally not as easily satisfy the near-permanent requirement" of the legitimate-business-interest test. *Id.* at *29. However, as the special concurrence warns, these should not be taken as categorical pronouncements for every case. *Id.* at *34 (Hudson, J., specially concurring) ("In short, I do not believe that professional services indicate substantial relationships as a matter of law.").

Moreover, the facts and circumstances of a case will need to be viewed in light of the policy from which the legitimate-business-interest test arose in the first instance – "protecting a

[3] Based on its detailed analysis of prior Illinois Supreme Court cases, the lead opinion in *Reliable Fire* found that "decisions of our supreme court track the common-law rule that a restraint must protect some legitimate interest of the promisee." *Reliable Fire*, 2010 WL 4967924 at * 19.

person's ability to pursue his or her chosen occupation." *Id.* at *19. As the lead opinion in *Reliable Fire* pointed out, "[t]he inquiry into whether the employer desires to prohibit competition *per se* or whether the employer has an interest over and above stifling competition is, therefore, logically a threshold question, although not always, as in *Lawrence & Allen.*" *Id.* at *19; *see also id* at *27 ("[R]estrictive covenants are a restraint on trade, and courts will strictly construe them to ensure that their intended effect is not to prevent competition *per se.*"). Of course, only time and an Illinois Supreme Court decision will provide the complete framework for determining whether the scope of a restrictive covenant is reasonable.

Until then, we have the legitimate-business-interest test, which now appears only to be a partial or incomplete framework. Nevertheless, it remains advisable whenever possible for businesses to draft restrictive covenants so as to conform to one of the two general situations courts have recognized as representing protectable interests: "where (1) because of the nature of the business, the customers' relationships with the employer are near-permanent and the employee would not have had contact with the customers absent the employee's employment; or (2) the employee gained confidential information through his employment that he attempted to use for his own benefit." *Steam Sales Corp.*, 2010 WL 2970375, at *10. In addition, the overall guiding principle in determining whether the scope of the covenant will be upheld is whether it is attempting to do something "over and above" simply suppressing "ordinary" competition. *See Reliable Fire*, 2010 WL 4967924 at *30.

If you have any questions regarding drafting, seeking to enforce, or defending against the enforcement of restrictive covenants, contact Michael P. Tomlinson at Tomlinson Law Office, P.C. Mr. Tomlinson will help you ensure that your rights are protected to the fullest extent possible. For more information, call (312) 726-8770 or e-mail mtomlinson@tomlinson-law.com.