The Employment Counselor

General Counsel, P.C. – Your Legal Partner & Trusted Advisor

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In This Edition
of the Employment Counselor

For many employers, non-competition agreements are shrouded in mystery. The employer knows that such agreements could be a valuable tool to protect their business. However, how and when to effectively utilize non-competition agreements can be a daunting legal minefield. This edition of *The Employment Counselor* provides an in-depth analysis of non-competition agreements which, we hope, will provide a valuable resource for employers.

In the first article, we examine the factors to consider in deciding whether an employer needs to use non-compete agreements, as well as how to institute these agreements. In the second article, we examine what makes a covenant not to compete "reasonable," and therefore enforceable by the courts. Finally, in the third article, we describe the various forms of relief available to those with enforceable covenants.

All employers should consider whether a non-competition agreement should be implemented to protect their business. We hope this edition of *The Employment Counselor* is informative and helps employers understand non-competition agreements.

Covenants Not To Compete:
When Do You Need Them, How Do You Implement Them?

It would be devastating for a Coca-Cola executive to jump ship to Pepsi Co. and spill all of his or her accumulated knowledge about how Coca-Cola does its business to its longstanding competitor. The same may be true of your company. Your business may be based on the workings of a particular patent, or may depend on a carefully developed client list—information that must be kept secret if you are to maintain your competitive edge. An employee with access to these assets could be seen as an asset to your competitors, or could decide to start his or her own version of your business. One of the best ways to protect your business from this potential threat is through a covenant not to compete.

A covenant not to compete is a contract between an employer and an employee whereby the employee agrees not to work for a competitor or become a competitor for a certain period of time after leaving the employ of the employer. A covenant can prevent a former employee from (1) forming a new business in competition with yours; (2) working for a competitor; (3) taking your business' proprietary information to a competitor; (4) luring your clients away from you; and (5) luring current employees away from you. Although historically disfavored as a restraint to open trade, courts today have recognized that the modern economy thrives on innovative technology and intense competition, and, thus, allow for covenants that place reasonable restrictions on how long a former employee must wait before being able to compete against your business.

So when do you need a covenant not to compete? You should strongly consider covenants for employees who have access to nonpublic information, such as trade secrets and client lists, and employees that provide unique services—especially those that require state licensing or certification. You need to ask yourself, "If this employee became a competitor, would they have a special edge against my business?" As an example, McDonald's does not have covenants preventing its fry cooks from working for other fast food chains, but surely has covenants with the marketers that conducted and compiled the consumer research McDonald's relied upon to craft its next ad campaign. Also consider covenants for employees that have developed relationships with your clients, as those relationships could be used to lure your clients to a competitor.

Covenants not to compete are also essential in the sale and purchase of businesses. If your business purchases the assets of another, you do not want the former owners using the old business' assets, such as its client list, to start a

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General Counsel, P.C.

Located in McLean, Virginia, General Counsel, P.C. provides legal representation to businesses and non-profit organizations in Virginia, Maryland, and Washington, D.C. Our representation can be divided into four primary categories: business/corporate law; labor/employment law; state/federal court litigation; and estate/business succession planning.

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The "Reasonable" Covenant Not to Compete

While courts are willing to enforce covenants not to compete, judges will construe the terms of those covenants strictly, against the employer. Only "reasonable" provisions will be enforced since covenants not to compete inhibit the freedom of trade. Therefore, it is important to carefully craft any covenant with the assistance of legal counsel so that it will withstand scrutiny of the courts.

The most important consideration in drafting a covenant not to compete is to identify what the particular needs of your business are. Where do you compete for business? What is the exact nature of your business? What are the duties of the employee who will be signing the covenant, and what kind of trade secrets or other private information does he or she have access? This is important because the courts will only enforce "reasonable" covenants, and will ask these three questions to determine if a given covenant is reasonable:

1. *Is the restraint, from the standpoint of the employer, reasonable in the sense that it is not greater than necessary to protect the employer in some legitimate business interest?*
2. *Is the restraint, from the standpoint of the employee, reasonable in the sense that it is not unduly harsh or oppressive in curtailing his or her legitimate efforts to earn a livelihood?*
3. *Is the restraint reasonable from the standpoint of good public policy?*

For the first question, the court will look closely at the nature of the employer's business. An employer clearly has a legitimate business interest in areas that are within its business practice, but not for areas that are beyond its practice. For example, a company that builds airplane engines and nothing else has a business interest in the market for airplane engines, but not other parts of the airplane, like the wheels.

When considering whether the covenant is unduly harsh on the employee, the court will look to whether the covenant makes it unreasonably difficult for the employee to be employed. A television station that seeks to prohibit its employees from working for any other television station in the United States would be seen as unduly harsh.

Finally, in terms of public policy, the court will look at the effect the covenant will have on the public, and whether the restriction is modest enough to not offend the public interest in free trade and competition. Protecting trade secrets and confidential client lists for a limited time are sufficiently important interests, for example, while forbidding employees from working for your competitors for the rest of their lives is not.

Ultimately, "reasonableness" is a balancing act between the three different kinds of restrictions that covenants not to compete offer: the duration of the restriction, the size of the geographic area where the restriction applies, and breadth of activity to be restricted. The broader any one of these restrictions is, the more narrow the others will need to be in order for the covenant to be reasonable, and all three will be assessed within the perspectives of the employer, the employee, and the general public.

In general, courts find reasonable those covenants that restrict an employee from engaging in the same kind of work he or she performed for the employer in the geographic area the employer does business for a period of two years after termination. Courts are also willing to enforce prohibitions on former employees soliciting current employees, or business clients, for the same period. However, the facts and circumstances of your business may require broader protection in one area than another.

The Virginia Supreme Court, in *New River Media Group, Inc. v. Knighton*, 245 Va. 367, 429 S.E.2d 25 (1993), upheld a covenant against an employee disc jockey wherein the employee could not join a competing radio station within 60 air miles of the employer's broadcast station for twelve months after termination. The radio station evidently decided that it was willing to make the covenant enforceable for only one year instead of two in order to make sure that the coverage area was suitably large to protect the station. In *Advanced Marine Enterprises, Inc. v. PRC, Inc.*, 256 Va. 106, 501 S.E.2d 148 (1998), the same court upheld a covenant that prevented former employees, for a period of eight months, from "rendering competing services to" or "solicit[ing] any customer of [the employer] for whom Employee performed services while employed by [the employer], within 50 miles of [any of the employer's] office[s]," even though the employer had over 300 offices worldwide. The duration and breadth of activity were narrow enough to allow the broader geographic scope to be reasonable.

Covenants not to compete that do not specify a duration, a geographic area, or the particular activities at issue will typically be read as though being unlimited in nature, and thus unreasonable restraints on trade. Ambiguities in noncompete agreements will be read against the employer and in favor of the employee, making it much more likely that the covenant will be found to be unreasonable. Thus it is critical to draw clear restrictions on each aspect of the covenant.

Should any part of a covenant not to compete be deemed unreasonable by a court, the tendency in Virginia has been to not enforce the entire covenant. This makes it all the more important that each covenant be carefully drafted. Since the covenant is a contract like any other, it is typical to include a severability provision so that if one part of the covenant is unreasonable, the other parts may still be enforced. Virginia courts have been reluctant to honor such clauses, however.

Before drafting a covenant not to compete, it is recommended that you consult legal counsel. ▲

When A Competitor Hires Your Former Employee:

Enforcing Your Rights

Your worst fear has been realized: a former employee with access to your trade secrets or confidential client information has joined a competitor, or has started a new firm in direct competition with yours. What can you do to protect your business from this threat? If you act swiftly, with the assistance of legal counsel, there are a host of legal remedies available that may immediately stop the former employee from continuing to harm your business, recover monies lost due to unfair competition, and even sanction the competitor that hired your former employee. Which remedies are available to you will depend on the factual circumstances of each case and the terms of your covenant not to compete.

Perhaps the most crucial concern for any employer in this situation is to move quickly to address the problem. Failure to enforce your rights in a timely fashion can render your claims time-barred under the applicable statutes of limitation. Failing to act expediently also lends credence to the defense that you have failed to mitigate your damages. In other words, the longer you wait to act, the more you exacerbate your own damages and make it harder to recover.

An enforceable covenant not to compete affords the greatest access to legal remedies. Without such a covenant, the options are much more limited. Under the common law, an employee, including an employee-at-will, has a fiduciary duty of loyalty towards his or her employer during the course of employment. In Virginia, the duty of loyalty requires, among other things, that an employee not compete with his or her employer

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during the course of employment. *Hilb, Rogal & Hamilton Co. of Richmond v. DePew*, 247 Va.240, 440, S.E.2d 918 (1994). While not a cause of action in itself, an employee who engages in one of the acts described below while still an employee with your firm is violating their duty of loyalty, whether a covenant not to compete is in effect or not. However, once the employee leaves your company, the duty of loyalty ends and the employee is free to compete against you, with some limited exceptions as described below. Therefore, covenants not to compete afford the employer more legal protections, and also continue to provide protection after the term of employment is terminated.

Here's an overview of the legal avenues available to employers:

I. Injunction

An injunction is an equitable request that a court issue an order preventing the former employee from continuing to act in violation of the covenant or other applicable laws. If the former employee was hired by a competitor, for example, the injunction could prohibit the employee from working for the competitor. If your former employee had access to client records, then left to start his or her own competing business and began contacting your clients, the injunction could prohibit the former employee and his business from contacting your clients. The purpose of the injunction is not to recover damages—it is only to prevent certain conduct that is in violation of the covenant or the law. As such, an injunction is often not the only remedy that an employer might request.

One advantage of an injunction is that the offending conduct may be halted quickly, without having to wait all the way through to trial. To obtain such a preliminary injunction, the petitioner must show (1) a likelihood of success on the merits; (2) whether the petitioner is likely to suffer irreparable harm if the injunction is not granted; (3) whether the petitioner has an adequate alternative remedy at law; (4) the extent the defendant will be harmed by the injunction; and (5) that the injunction would not be against public interest. See *Blackwelder Furniture Co. v. Seilig Manufacturing Co.*, 550 F.2d 189 (4th Cir. 1977) (applying Virginia law). Essentially, the greater the potential harm to the petitioner and the less the potential harm to the former employee, the more likely a preliminary injunction will be granted quickly, thus protecting the petitioner's business while trial is pending.

A preliminary injunction is of particular importance in the enforcement of a former employee's rights since otherwise the offending conduct, along with the damage caused, will not stop until the conclusion of the trial, at best—something that may take over a year.

II. Tortious Interference with Contractual Relations

There are two distinct ways that this claim may be raised: (1) when a competitor induces your former employee to violate the covenant not to compete, and (2) when a former employee induces your client to break their contracts with you.

In either case, there must be an existing contract or covenant with a third party (the former employee in the first instance, the client in the latter), knowledge of the existence of the contract by the wrongdoer, intentional interference with the contract by the wrongdoer, a breach of the contract by the third party induced by the wrongdoer, and resulting damages. *Chavez v. Johnson*, 230 Va. 112, 335 S.E. 2d 97 (1985).

While an action for breach of contract against the third party can only recover those damages contemplated under the terms of the contract, a claim of tortious interference against the wrongdoer can recover additional damages, such as harm to reputation, loss of the benefits of the contract, emotional distress, and, potentially, even punitive damanges.

III. Intentional Interference with Business Relations

Unlike tortious interference with contractual relations, intentional interference with business relations does not require the existence of a contract, and generally addresses damages to businesses that are more indistinct. To recover, there must be (1) the existence of a business relationship or expectancy; (2) a probability of economic benefit; (3) the wrongdoer must have knowledge of the relationship or expectancy; and (4) a reasonable certainty that absent the wrongdoer's intentional misconduct, you would have continued in the relationship or realized the expectancy. *Glass v. Glass*, 228 Va 39, 321 S.E.2d 69 (1984).

Obviously, a "relationship" or "expectancy" is less definite than an actual contract in hand. One example would be a long-term client that makes a contract with you every month for delivery of goods. Then, after your former employee leaves for a competitor and contacts the client in violation of the covenant not to compete, the client stops making new contracts with you. While the former employee and competitor would not be liable for interference with contractual relations since the client did not breach an existing contract, you would have had an expectation that, were it not for your former employee's wrongful breach of the covenant, the client would have continued to contract with you in the future. You would then be entitled to damages resulting from the loss of those expected contracts.

IV. Civil Conspiracy

In some cases where one of the above interference claims can be alleged, there may also be a claim for civil conspiracy against the former employee and the competitor that hires the former employee. A civil conspiracy exists where there is an agreement between two or more persons to accomplish an unlawful purpose or to accomplish a lawful purpose by unlawful means, resulting in damages. *Glass v. Glass*, 228 Va. 39, 321 S.E.2d 69 (1984). While there cannot be civil conspiracy between a corporation and an employee of that corporation, since they are considered as one entity under the law, there can be civil conspiracy between a competitor and one of your employees, such as when the competitor and your employee agree to wrongfully cause your clients to break contracts with your company as the employee leaves to join the competitor. Under civil conspiracy, you can recover from the former employee and the competitor any damages proximately resulting from the wrongful conduct, in addition to punitive damages.

Should the conspiracy be willful and malicious in nature, such as by a disaffected employee with an axe to grind, recovery may be had under Virginia Code § 18.2-500, where a prevailing employer is entitled to treble damages (including loss of profits), the costs of litigation, and reasonable attorney fees.

V. Misappropriation of Trade Secrets and Proprietary Information

Misappropriation of trade secrets is a statutory basis for relief under the Uniform Trade Secrets Act, with or without a covenant not to compete in effect. The Act describes "trade secrets" as:

> *...information including, but not limited to, a formula, pattern, compilation, program, device, method, technique, or process that:*
> *1. Derives independent economic value, actual or potential, from not being generally known to, and not readily ascertainable by proper means by other persons who can obtain economic value from its disclosure or use, and*
> *2. Is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.*

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new firm to compete with yours. The covenant can protect the rights of the buyer from unexpected competition down the road and ensure that the assets purchased truly belong to the buyer and are not subject to unauthorized dissemination.

Implementation. If you have decided that you want to have a covenant not to compete as part of an employee contract or business asset transaction, that covenant will not be enforceable unless it has the basic elements of any other contract, namely consideration and acceptance.

In Virginia, requiring a prospective employee to sign a covenant not to compete as a condition for employment is considered a legal consideration and will make the covenant enforceable, assuming that the covenant's terms are reasonable (the subject of another article in this publication). But what if you want to impose a covenant on a current employee? The Virginia Supreme Court held in *Paramount Termite Control Co. v. Rector*, 238 Va. 171, 380 S.E.2d 922 (1989), that continued employment after the acceptance of the covenant constituted sufficient legal consideration to make the covenant enforceable. However, in *Mona Electric Group, Inc. v. Truland Service Corp.*, 193 F. Supp. 2d 874 (E.D. Va. 2002), a federal district court applying Virginia law apparently overlooked the *Rector* decision and held that continued employment was not sufficient consideration to enforce a covenant.

Since the Virginia Supreme Court is the ultimate arbiter of the status of Virginia law, the *Rector* decision should be the most authoritative. However, the best way to ensure that a covenant has consideration when given to a current employee is to provide some kind of additional benefit, such as a raise or a bonus, as a reward for accepting the covenant. Thus, a good time to institute a covenant not to compete with a current employee would be when he or she is already being promoted—the raise for the new position would also serve as consideration for the new covenant.

In the sale or purchase of a business or business interest, a covenant not to compete should be included as an ancillary contract. The sale/purchase of the business then serves as the legal consideration for the terms of the contract.

In addition to consideration, there needs to be acceptance of the covenant. The acceptance needs to be explicit and not merely assumed. In *Persinger & Co. v. Larrowe*, 252 Va. 404, 477 S.E.2d 506 (1996), the Virginia Supreme Court held that a general partner was not bound by a noncompete covenant that he did not sign, but by its terms was to be automatically applied to all the partners of the partnership. Mere awareness of the covenant was not sufficient. Because covenants not to compete are a constraint against free trade, courts strictly evaluate whether consideration and acceptance have been met. Without the general partner's signature on the covenant, it could not be enforced against him. Therefore, make sure the employee signs the covenant.

If you decide that your business needs covenants not to compete with its employees, it is advised that you consult legal counsel to ensure those covenants are appropriate and enforceable. ▲

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Virginia Code § 59.1–336. "Misappropriation" is defined as:

> *1. Acquisition of a trade secret of another by a person who knows or has reason to know that the trade secret was acquired by improper means; or*
> *2. Disclosure or use of a trade secret of another without express or implied consent by a person who*
> > *a. Used improper means to acquire knowledge of trade secret; or*
> > *b. At the time of disclosure or use, knew or had reason to know that his knowledge of the trade secret was*
> > > *(1) Derived from or through a person who had utilized improper means to acquire it;*
> > > *(2) Acquired under circumstances giving rise to a duty to maintain its secrecy or limit its use;*
> > > *(3) Derived from or through a person who owed a duty to the person seeking relief to maintain its secrecy or limit its use; or*
> > > *(4) Acquired by accident or mistake.*

Thus, if a former employee provides your trade secrets to a competitor, you may be able to recover against the former employee and the competitor for any damages that result, along with any unjust enrichment that the competitor earned as a result of the misappropriation, and any reasonable royalties that may exist. For misappropriation that is "willful and malicious," the courts will award attorney fees to the prevailing party, and for especially egregious conduct, punitive damages up to $350,000 are available.

VI. Others (Replevin, Conversion, Unfair Competition, Accounting)

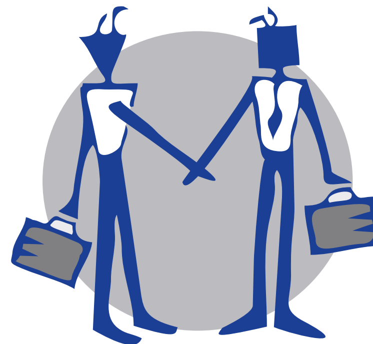
Depending on the facts of a particular case, other claims may be asserted against the former employee, with or without a covenant not to compete in effect.

Replevin and conversion involve situations when the former employee steals from your company, such as by physically taking client lists or computer hardware. Replevin seeks the return of the physical goods, while conversion seeks money damages instead of the actual property.

An action for accounting applies when the employee in question had access to the fiduciary matters of the firm, such as when the employee was one of the partners in a partnership. This action forces the former employee to account for the monies in the firm to show that the firm has not been shorted.

Unfair competition arises when the former employee starts a business with a similar name as yours, or sells products that could be confused with yours. When the resemblance between the respective trade names and products are so close as to cause confusion, the courts will find prejudice against the former employee and enjoin the practice.

Consult legal counsel as soon as you discover that a covenant not to compete may have been violated by one of your current or former employees so that you can discuss what remedies may be appropriate in your situation. ▲



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