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## Taking the Offensive:

### A Case Study on Attacking Noncompete Agreements

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In today's business environment, where a company's revenues may depend on its ability to operate new businesses or grow existing ones, the practice of hiring executives, managers and employees away from competitors is commonplace. In many cases, however, star candidates may be subject to agreements not to compete with their present employer that, if properly drafted, may preclude them from being employed by a competitor. If a company hires a candidate who is restricted by such a noncompete agreement, the former employer will not only sue the employee for breaching the agreement, but likely will sue the hiring

company for interfering with the contractual relationship with the employee.

Noncompete agreements are not ironclad, however. In fact, the agreement may not be worth the paper it's written on. But before hiring a star candidate, a company should assess whether any noncompete agreement the employee may be subject to is enforceable. And if a company is sued by a competitor over an unenforceable noncompete agreement, it may have an excellent opportunity to convert its litigation position from a defensive to an offensive one and may, in some cases, recover attorneys fees and damages against the competitor for commencing frivolous litigation.

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## The “NewCo” Case

Consider the following case of an actual company — call it “NewCo” — that hired managers away from a competitor — “OldCo” — to operate a new business providing background investigations to the U.S. government. The new hires had all signed noncompete agreements with OldCo. Prior to hiring the employees, NewCo investigated the noncompete agreements and determined that they were not enforceable for a number of reasons.

Of course, OldCo promptly sued NewCo seeking, among other things, an injunction. After the lawsuit was filed, however, it became increasingly apparent that OldCo’s litigation was frivolous — a sham suit filed in order to hamper NewCo’s ability to fulfill its obligations under a valuable contract with the federal government. NewCo went on the offensive, filing counterclaims against OldCo for tortious interference with NewCo’s government contract and seeking both damages and attorney’s fees.

Five months after OldCo filed its suit, and after an extensive hearing on the request for a preliminary injunction, a state court in Western Pennsylvania denied the injunction and sanctioned OldCo for commencing the sham litigation. The court awarded NewCo one of the largest attorneys fee awards in Pennsylvania history and allowed the company the opportunity to prove its damages resulting from OldCo’s interference with the government contract. Ultimately, OldCo paid NewCo a significant amount of money to settle the case.

## The Lessons of NewCo: Analyzing the Noncompete Agreement

While the law on noncompete agreements differs from state to state, the fol-

lowing questions can help a company analyze whether attacking — or enforcing — a noncompete agreement would likely be successful. The answers to many of these questions allowed NewCo to meet its business objectives — to hire experienced managers to operate its new business — and to convert its defensive position in the lawsuit with OldCo into an offensive one.

**Did the employee receive something of value in exchange for limiting his or her rights under the noncompete agreement?** A noncompete agreement must be supported by “adequate consideration.” That is, the employee must have received something of value in exchange for agreeing to be restricted by the agreement.

A noncomplete is generally considered supported by adequate consideration if the employee signed it at the start of employment — the employee received the benefits of the job as adequate consideration for giving up his or her right to potential future employment with a competitor. In addition, a minority of jurisdictions consider noncompete agreements to be enforceable even if they were signed months or years after the initial employment, reasoning that continued employment provides the necessary consideration.

In those jurisdictions that don’t recognize continued employment as adequate consideration, a noncompete agreement signed after the start of employment can be enforced only if the employee receives new consideration — some adequate benefit that he or she was not otherwise entitled to receive. The new consideration can be in the form of money, benefits or a change in employment status from an at-will to a contract employee, for example.

In the NewCo case, the employees

signed the noncompete agreements after the start of their employment with OldCo, and, although these employees received a performance bonus of several thousand dollars, the same bonus was also paid to several dozen other employees who refused to sign the noncompete agreement. Because they were already entitled to receive the performance bonus, the employees received no new benefit in consideration for signing the noncompete agreement and the agreement was therefore invalid and unenforceable.

**Does the noncompete agreement serve some legitimate protectable interest?** Courts strictly construe noncompete agreements because they restrict competition. These agreements are generally only enforced if they serve some legitimate interest of the company that is considered “protectable.” In most jurisdictions, legitimate protectable interests include customer goodwill, trade secrets and specialized training.

Customer goodwill is created when an employee nurtures, develops or establishes customer relationships on behalf of the employer. The employer, not the employee, owns the goodwill and has a protectable interest in it. Where, as in the NewCo case, the employee whose noncompete is at issue has little contact with customers or doesn’t develop relationships with them, customer goodwill is not a protectable interest served by the noncompete agreement and cannot support its validity.

An employee’s access to trade secrets is also a legitimate protectable interest served by a noncompete agreement. Simply defined, a trade secret is information owned by the company that is not publicly available and that provides the company with a competitive advantage. Some examples of trade secrets include customer lists and proprietary

formulas, methods and procedures. In the NewCo case, while OldCo alleged that its trade secrets were protectable interests served by the noncompete agreement, the trade secrets were actually owned by the U.S. government and were also widely known in the industry.

Specialized training — training and skills provided by the employer to an employee — can also be a protectable interest served by a noncompete agreement, as long as the training provides more than just general techniques commonly known in the industry. Typically, an employer provides specialized training when an employee begins his or her employment as a novice with little or no experience. In the NewCo case, the managers whose employment was at issue had substantial experience in background investigations prior to being employed by OldCo. OldCo had not provided any specialized training or special skills that were protectable interests served by the agreement.

Where, as in the NewCo Case, there is no protectable interest served by a noncompete agreement, the agreement is invalid as an unlawful restraint of trade.

**Is the noncompete agreement reasonably limited in duration and territory?** The duration of and territory covered by the noncompete agreement must be reasonable in order to be enforceable. In other words, these provisions must not overreach; the interests the employer seeks to protect under the noncompete agreement must be balanced against the hardship imposed by the restriction on the employee.

For example, where the noncompete agreement is intended to protect the employer's customer goodwill, the agreement may last no longer than the time it takes a new hire to demonstrate his or her effectiveness to customers. In

general, one year is usually considered reasonable, two years may sometimes be appropriate, and three years is highly questionable. Similarly, where the noncompete agreement is intended to safeguard a trade secret, it may be in effect no longer than the time it takes to develop the trade secret. And where the agreement compensates the employer for providing specialized training, it may last no longer than the time it takes the employee to develop the specialized skills or training.

The employer's protectable interest must also be balanced against the territory covered by the noncompete agreement. For example, in customer goodwill cases, the territory may be limited to the area covered by the employee during his or her employment — although management employees may be subject to a broader territorial restrictions than non-management employees. In trade secret cases, the noncompete agreement may extend to areas where the employer's product is primarily sold or where its services are rendered.

In some jurisdictions, courts must read noncompete agreements strictly with respect to the duration and territory of the limitations. A noncompete agreement will not be enforced if the duration and territory provisions are not reasonable as written, and the court may not modify the agreement to make the terms reasonable. In other jurisdictions, courts have some discretion to modify noncompete agreements to make the duration and territory provisions reasonable.

**Has the employer historically enforced its noncompete agreements?**

If an employer has not historically enforced noncompete agreements against employees holding the same or similar positions, the competitor may argue that company has waived the enforceability of

the noncompete agreement against the employee it wishes to hire. For example, in the NewCo case, with very limited exception, OldCo failed to enforce noncompete agreements against thousands of employees who had previously left the company. By failing to apply a uniform approach to enforcing its noncompete agreements, OldCo waived its right to enforce the agreements against the employees hired by NewCo.

**Was the employee fired for poor performance or laid off?** In some jurisdictions, courts will not enforce noncompete agreements if an employee is laid off or fired for poor performance. An employee who is fired for poor performance is not a competitive threat to his or her former employer such that the employer needs the protection of the noncompete agreement, although this exception will not apply to termination cases where the employee intentionally commits some egregious act to get fired.

**Was the noncompete agreement part of the sale of assets from one company to another?**

In some jurisdictions, where a company sells its assets to another company, the purchaser will not be able to enforce the seller's noncompete agreement unless the agreement expressly permits assignment to a purchasing company. Courts in these jurisdictions hold that it is not reasonable to allow an entity that was not an original party to a noncompete agreement to enforce the agreement, unless employees expressly consent through an assignment provision in the agreement. The lack of an assignment provision was an issue in the NewCo case, where OldCo had purchased its assets from another company and the existing noncompete agreements did not have express assignment provisions.

**Are there public policy arguments against enforcing the noncompete agreement?** Noncompete agreements



may not be enforced where there is a vital public demand for the services provided by the employees restricted by the agreements and the demand outstrips the industry's capacity to meet it. For example, if the patient demand for a medical specialty is greater than the number of physicians who are practicing in the geographic territory covered by a noncompete agreement, courts will generally not enforce the agreement on public policy grounds.

In the NewCo case, national security interests and the demand for the services of the employees subject to the agreements — federal background investigations — far exceeded the industry's capacity and weighed against enforcing the noncompete agreements.

## Taking the Offensive

When faced with possible — or actual — litigation over the enforceability of noncompete agreements, companies need to develop a strategic plan that matches their business objectives.

In the NewCo case, the business objectives were clear — to develop and operate a new business, providing background investigations to the U.S. government — and NewCo needed OldCo's former employees to meet that objective. NewCo and its litigation advisers identified and aggressively exploited the weaknesses in OldCo's noncompete agreements to NewCo's advantage.

By taking the offensive in the enforcement suit, not only did NewCo succeed in invalidating the agreements, but it garnered a significant settlement and full reimbursement of the attorneys fees it incurred defending against OldCo's frivolous litigation. After the litigation was resolved, NewCo was also able to hire additional employees from OldCo and now operates a multi-million dollar business providing federal background investigations.

Sometimes the best defense is a great offense. •



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