Addressing Increasing Uncertainty in the Law of Non-Competes

Employment and Labor

CHEAT SHEET

- ***Blue pencil.*** In many US states, courts are permitted to reform, or “blue pencil,” a non-compete agreement if it is overly broad. Depending on the jurisdiction, that court may be permitted to narrow portions of the agreement that it finds unreasonable, or sever invalid terms while preserving others.
- ***A wide net.*** In July 2016, the Nevada Supreme Court created a significant dilemma for employers in Golden Road Motor Inn, Inc. v. Islam by invalidating a non-compete agreement in its entirety for being too broad. In response to the decision, the Nevada legislature mandated that any non-compete agreement seemed overly broad should be revised instead of invalidated.
- ***Sudden shift.*** There are two structural elements that make the law of employee non-competes susceptible to a sudden regulatory shift: First, the interpretation and enforcement of non-competes is controlled by the common law of contract, and second, the common law of non-competes is not fully established.
- ***Protection direction.*** With uncertainty surrounding the legal framework of non-compete agreements, employers should closely follow relevant appellate court decisions, limit the language of their own policies, and revisit standards regularly.

During the past few years, non-competes — agreements that employees sign limiting their future right to work in positions that compete with their current employer — have been the subject of remarkable controversy. A variety of sources including the New York Times op-ed page and former US President Barack Obama have argued that the use and enforceability of such covenants should be limited because they stifle the economy and unfairly restrict the ability of workers, including workers in low-paying positions, to find new jobs. The attorneys general of both New York and Illinois have actively pursued companies in their respective jurisdictions for perceived overuse of non-compete covenants, resulting in some well-publicized consent decrees. On the other hand, many companies regard non-competes as essential to their willingness to entrust workers with sensitive information and training.

Legislation proposing various limitations on the validity and enforceability of non-competes has been proposed in the US Congress and in numerous state houses. These proposed legislative changes have been closely watched by companies who rely on non-competes to protect their interests. Corporate executives and representatives of trade organizations have testified at legislative hearings in numerous jurisdictions.

But while the activities of legislative bodies with respect to employee non-competes are often closely followed by employers and trade organizations, the activities of appellate courts — whose decisions can be just as disruptive to the existing regime — have not received the same attention. This article examines this issue through the lens of a recent decision by the Nevada Supreme Court regarding the "blue pencil" doctrine and suggests ways for employers with a significant interest in the enforceability of employee non-competes to prepare themselves for the possibility of unexpected change to the applicable legal framework, including following closely the appellate courts in relevant jurisdictions, ensuring that covenants are appropriately tailored to the employees they cover, and taking advantage of opportunities to regularly review and recalibrate the covenants applying to their employees.

The blue pencil doctrine

Under the law of many states, courts are permitted to reform, or "blue pencil," a non-competition covenant that is, on its face, unenforceably overbroad. Depending on the jurisdiction, the court may be permitted — or in some cases, required — to narrow a covenant that it finds unreasonable as written to render it enforceable or, alternatively, to sever invalid terms while preserving others. Thus, in many cases, the focus of the courts is not on whether the non-competition covenant will be enforced as written but rather on whether a covenant can be constructed that reflects the parties' agreement and properly balances the former employer's need for protection from unfair competition with the employee's right to seek new employment and to earn a living. While the majority of jurisdictions in the United States permit courts to blue pencil non-competes to at least some degree, the doctrine has long been the subject of debate.

The proponents of blue penciling note that voiding an entire covenant because of modest overreach "would frustrate the intent of the contracting parties," particularly given that "a reasonable time period or geographical area is not capable of precise calculation." They point out that the existence of a non-compete covenant is evidence of the parties' shared intent to impose limitations on the employee's right to move to a competitor and that an all-or-nothing approach to enforcement may effectively frustrate that intent.

On the other side of the argument, courts that refuse to blue pencil non-competes have focused on three primary concerns. First, courts have observed that blue penciling "is tantamount to the

construction of a private agreement and that the construction of private agreements is not within the power of the courts." Second, courts have expressed concern that blue-penciling creates an incentive for the employer to overreach, knowing that if the non-competition covenant is found unenforceably broad as drafted, a narrower version will be substituted and enforced. Third, courts note that "for every covenant that finds its way to court, there are thousands that exercise an in terrorem effect on employees who respect their contractual obligations and on competitors who fear legal complications if they employ a covenantor." Because most employees simply comply with their non-competes rather than challenging them in court, the argument goes, the law should provide a strong incentive for employers not to overreach.

Golden Road Motor Inn

It was against the background of this debate that, in July 2016, the Nevada Supreme Court decided *Golden Road Motor Inn, Inc. v. Islam*, 376 P.3d 151 (Nev. 2016). In that case, Atlantis Casino Resort Spa had a contract with its employee, Sumona Islam, that included a covenant not to accept employment with another gaming establishment within a 150-mile radius for one year after the end of her employment with Atlantis. Islam was a casino host at Atlantis and was responsible for managing Atlantis' relationship with some of its most frequent guests.

Islam left Atlantis to work in an identical position for a competing casino, Grand Sierra Resort, located less than four miles from Atlantis. In addition, she took the contact information for many of Atlantis' frequent customers with her. She entered that information into the computer database at Grand Sierra and contacted many of her former customers at Atlantis, encouraging them to gamble at Grand Sierra instead. Atlantis sued and the trial court held that Islam had breached her non-competition covenant.

There were various other claims against both Islam and Grand Sierra at issue both in the trial court and on appeal but, for purposes of this article, we focus on the claim for breach of her non-competition covenant.

The Nevada Supreme Court examined the non-competition covenant at issue and found it overbroad in two respects. First, it found that the 150-mile radius was too wide, finding it "unlikely that Islam would be luring players from Atlantis" to another casino 150-miles away. Second, the court found that a covenant prohibiting any type of employment with another gaming establishment was unnecessarily restrictive and unreasonably prevented Islam from gainful employment.

Importantly, neither of those bases for overbreadth was reflected in the facts of Islam's case. She had gone to work in an identical position for a casino less than four miles away. Nevertheless, the court found that, as drafted, the non-competition covenant was substantially broader than necessary to protect Atlantis' business interests.

The court's next sentence may strike fear into the hearts of employers who rely on non-competes: "Under Nevada law, such an unreasonable provision renders the non-compete agreement wholly unenforceable." Having found the terms of the non-competition covenant to be overbroad, the court adopted an all-or-nothing approach to construction of the agreement and refused to grant Atlantis any relief on its claim. The majority expressed concern that any other action would essentially create a new contract for the parties from whole cloth, which, it concluded, the court lacked the power to do. The court was persuaded by many of the factors that have guided those jurisdictions that have refused to permit blue-penciling, including a concern that the doctrine "favors the employer by presuming the employer's good faith," encouraging employers to draft overbroad

covenants, and that the lack of consequences to the employer of overbroad non-competes has the effect of punishing employees who do not litigate but instead abide by the terms of their contract as written without litigation.

The three dissenting justices raised serious concerns about this holding. They noted that there was "no doubt that Islam and Atlantis agreed to restrict Islam's future employment as a casino host and that such a restriction is reasonable." Because a non-competition covenant barring Islam's actual conduct — going to work in an identical position for a competitor less than four miles away — would unquestionably have been reasonable, and because there was no evidence of bad faith on Atlantis' part, the dissenters took the position that granting relief to Atlantis was the best way to give life to the intent of the contracting parties. They further pointed out that reformation of a contract is a recognized equitable remedy and that, here, those equities clearly favored Atlantis.

Golden Road represented a cataclysmic shift for Nevada employers. One Nevada employment lawyer wrote, in an advisory to his clients, that Golden Road "will fundamentally impact the interpretation and enforceability of almost every non-competition agreement in Nevada." The Nevada court's decision created a significant dilemma for employers, particularly because the enforceability of non-competes is a fact-intensive inquiry the results of which can be difficult to predict in advance. On the one hand, employers would like to maximize the scope of the protections in their contracts. On the other hand, under the Nevada Supreme Court's approach, if the employer overreaches, there could ultimately be no protection at all.

In response to the resulting consternation, the Nevada legislature stepped in and effectively overturned *Golden Road*, quickly passing legislation that requires courts to blue-pencil overbroad non-competes. The law now provides that the court "shall revise the covenant to the extent necessary and enforce the covenant as revised," if the language is found to be overbroad.

But perhaps the most striking fact about the *Golden Road* decision is a procedural one. Despite the significance of its holding for Nevada employers, not a single employer or advocacy group filed an amicus brief before the Nevada Supreme Court. *Golden Road*, and particularly the lack of participation by the broader community of Nevada employers, underscores the importance of following not only potential developments in the legislature but those in the courts as well. And, as discussed in more detail below, employers that carefully tailor the scope of their non-competes and that revisit such clauses regularly are in the best position to weather the sorts of changes that may arise suddenly out of the appellate courts.

Sources of instability in the law of non-competes

The risk of such a sudden shift in the law exists in many areas. But there are two structural elements that make the law of employee non-competes particularly susceptible to the kind of rapid about-face that occurred in Nevada.

First, although legislative proposals have been frequently brought forward in recent years, the interpretation and enforcement of non-competes is primarily controlled in most states not by statute but by the common law of contract. While some states have enacted statutes that expressly govern when non-competes may be enforced, see, e.g., Cal. Bus. & Prof. Code § 16600 (prohibiting non-competes except as expressly permitted by statute); Mont. Code Ann. § 28-2-703 (same), the majority of states evaluate the validity and enforceability of non-competes under common law of contracts as developed by the courts. And, even where statutory schemes are in place, many factors pertaining to the enforcement or interpretation of non-competes may be outside the scope of the

statute and thus controlled by common law. In California, for example, the court cannot blue-pencil a non-competitive covenant to bring it into compliance with statutory prohibitions.

Second, and relatedly, the common law of non-competes is often not fully established. **Much of the litigation over non-competes occurs in the form of motions for preliminary injunction when, for example, an employer seeks to enjoin a former employee from working for a competitor.** In many of these cases, by the time an appeal could even be considered by the state's highest court, it has been mooted by the passage of time either because the employee's contractual period of restriction has come and gone or because the technology or asset the former employer was seeking to protect has long since been revealed. Thus, although non-competes may be the subject of frequent litigation in trial courts, they are much less frequently addressed by appellate courts, particularly states' highest courts. This can lead to a dearth of precedential decisions and leaves the law in many jurisdictions rather murky.

Taken together, these factors can lead to substantial uncertainty and instability in the law applied to non-competes. In Pennsylvania, for example, the blue-penciling of non-competes is still controlled largely by two Supreme Court cases that are more than 40-years-old and whose holdings can be difficult to reconcile.

Reading Aviation Service, Inc. v. Bertolet, 311 A.2d. 628 (Pa. 1973) concerned an attempt to enforce a non-competition covenant that contained no limitations as to geographic scope or duration. The Pennsylvania Supreme Court refused to enforce the covenant on the ground that it was overbroad and refused to blue-pencil the covenant — citing the same argument that the Nevada Supreme Court recently relied on in *Golden Road* — because modifying such overbroad clauses "tends to encourage employers […] possessing superior bargaining power over that of their employees and vendors to insist upon unreasonable and excessive restrictions, secure in the knowledge that the promise may be upheld in part, if not in full."

Just three years later, *in Sidco Paper Co. v. Aaron*, 351 A.2d 250 (Pa. 1976), the same court reached essentially the opposite result. Sidco concerned the enforcement of a non-competition covenant that prevented an employee from working in a similar business anywhere from Virginia to Massachusetts, even though his sales territory actually covered a much smaller area. Although it concluded that the covenant was overbroad on its face, the Supreme Court affirmed a narrower, blue-penciled geographic scope, emphasizing that this was necessary to prevent the wrongful conduct of the former employee. The court concluded: "The reason for this policy is a refusal to allow the employee to profit, at the expense of his former employer, from his wrongful and inequitable conduct." The Sidco court narrowly constrained *Reading Aviation*'s skepticism of the blue-pencil doctrine, finding that it should be applicable only to covenants that exhibit "gratuitous overbreadth," which is indicative of "an intent to oppress the employee and/or foster a monopoly, either of which is an illegitimate purpose."

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Although *Reading Aviation* and *Sidco* reach largely contradictory conclusions about the permissibility of blue-penciling, both remain good law in Pennsylvania and both are still regularly cited by litigants and by trial and intermediate appellate courts. Effectively, the law in Pennsylvania is that suggested

by the *Golden Road* dissent: Blue-penciling is permissible absent a showing of bad faith by the employer. But that regime has arisen not out of a clear statement of law from the Pennsylvania Supreme Court, but as a patchwork assembled by the lower courts' collective reading of the ambiguous tea leaves of *Reading Aviation* and *Sidco*.

Against the background of frequently uncertain and underdeveloped law, it is far easier for a state's highest court to adopt a policy — as the court did in *Golden Road* — that works a substantial change in the law on the ground. In the absence of the stability provided by statutory authority or the stare decisis considerations raised by robust and recent precedent, there is little to prevent a court from altering the law and undermining the plans of employers who have developed their contractual forms and policies in reliance on the law as it currently exists. As a result, it would not be surprising to see other courts take the approach of the Nevada Supreme Court and change the law of non-competes to avoid results they see as inequitable.

How can employers protect themselves?

With all this uncertainty about the legal regime that applies to non-competes, what should employers who rely on those covenants do to protect their interests? We recommend that employers take three common-sense steps.

- **Follow relevant appellate courts.** The key takeaway from Nevada's experience with Golden Road is that employers that rely on non-competes should monitor cases in the appellate courts in the jurisdictions where they have employees. Where cases raising significant issues related to non-competes are pending before those courts — particularly the highest court in a jurisdiction — employers and trade organizations should consider filing amicus briefs to ensure that the court is aware of the potential broad effects of the holdings sought by the parties. While such participation will not necessarily prevent a problematic result, it does at least ensure that the court is aware of the ramifications of its potential decision.
- **Don't overreach.** While the legal regimes applicable to the validity and enforceability of non-competes are highly variable from one state to another, there is one near-constant: The more narrowly tailored a covenant is to protection of the employer's legitimate interests, the more likely it is to be enforced. Consideration of what protection is actually necessary regarding each employee will help the employer design covenants that provide adequate protection but reduce the risk of being seen as overreaching. It is frequently better to draft a narrow covenant that the employer is confident will be enforced than a broad covenant whose enforceability may need to be litigated. This is particularly true where the same covenant is applicable to many similar employees. If a covenant applicable to many employees is voided or modified by a court, that ruling may preclude the employer from seeking to enforce that same covenant against other employees. In addition, some courts will consider evidence regarding whether an employer tailors its restrictive covenants to the particular situations of its employees when deciding whether those covenants are reasonable and, therefore, enforceable.
- **Revisit covenants regularly.** Because both the roles of particular employees and the competitive situations of employers change over time, it is important to regularly consider whether the scheme of non-competes in place strikes the proper balance between reasonability and protection of the employer's interest. A "set it and forget it" approach to non-competes, while perhaps simplest in execution, does not provide the best protection for the employer's interests. In some jurisdictions, for example, a non-competition covenant may only be entered into or strengthened if the employee receives new consideration at the time of

the agreement. Thus, the times when such new consideration is provided — when the employee receives a promotion, a raise, a bonus, or a grant of stock options, for example — are opportune times for the employer to examine whether the non-competition covenant applying to that particular employee is appropriate and adjust it if necessary. Those same junctures may also represent a change in employee job responsibility, which might likewise warrant a review of applicable covenants. And, indeed, a regular practice of reviewing the scope of existing non-competes may constitute further evidence of appropriate tailoring and good faith and thus may ultimately help the employer support the validity of those covenants in the event of litigation. Such a practice also provides a built-in, periodic opportunity for the employer to react to a court decision that alters the existing legal framework for the validity or enforceability of non-competes.

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Conclusion

In sum, while possible statutory changes often win more attention, employers should be cognizant of the possibility that state appellate courts may significantly change the law governing non-competes with little warning. By taking the practical steps outlined above, employers can put themselves in the best position to weather changes in this often uncertain area of the law.

Further Reading

Health Care Fin. Enterprises, Inc. v. Levy, 715 So. 2d 341, 343 (Fla. Dist. Ct. App. 1998).

CAE Vanguard, Inc. v. Newman, 518 N.W.2d 652, 655 (Neb. 1994).

Richard P. Rita Pers. Servs. Int'l, Inc. v. Kot, 191 S.E.2d 79, 81 (Ga. 1972) (finding that "employers can fashion truly ominous covenants with confidence that they will be pared down and enforced when the facts of a particular case are not unreasonable").

2017 Nevada Laws Ch. 324 (A.B. 276).

See, e.g., *Applied Materials, Inc. v. Advanced Micro-Fabrication Equip. (Shanghai) Co.*, 630 F. Supp. 2d 1084, 1091 (N.D. Cal. 2009) (finding that California law does not permit blue-penciling of a non-competition covenant to bring it into compliance with statutory prohibitions).

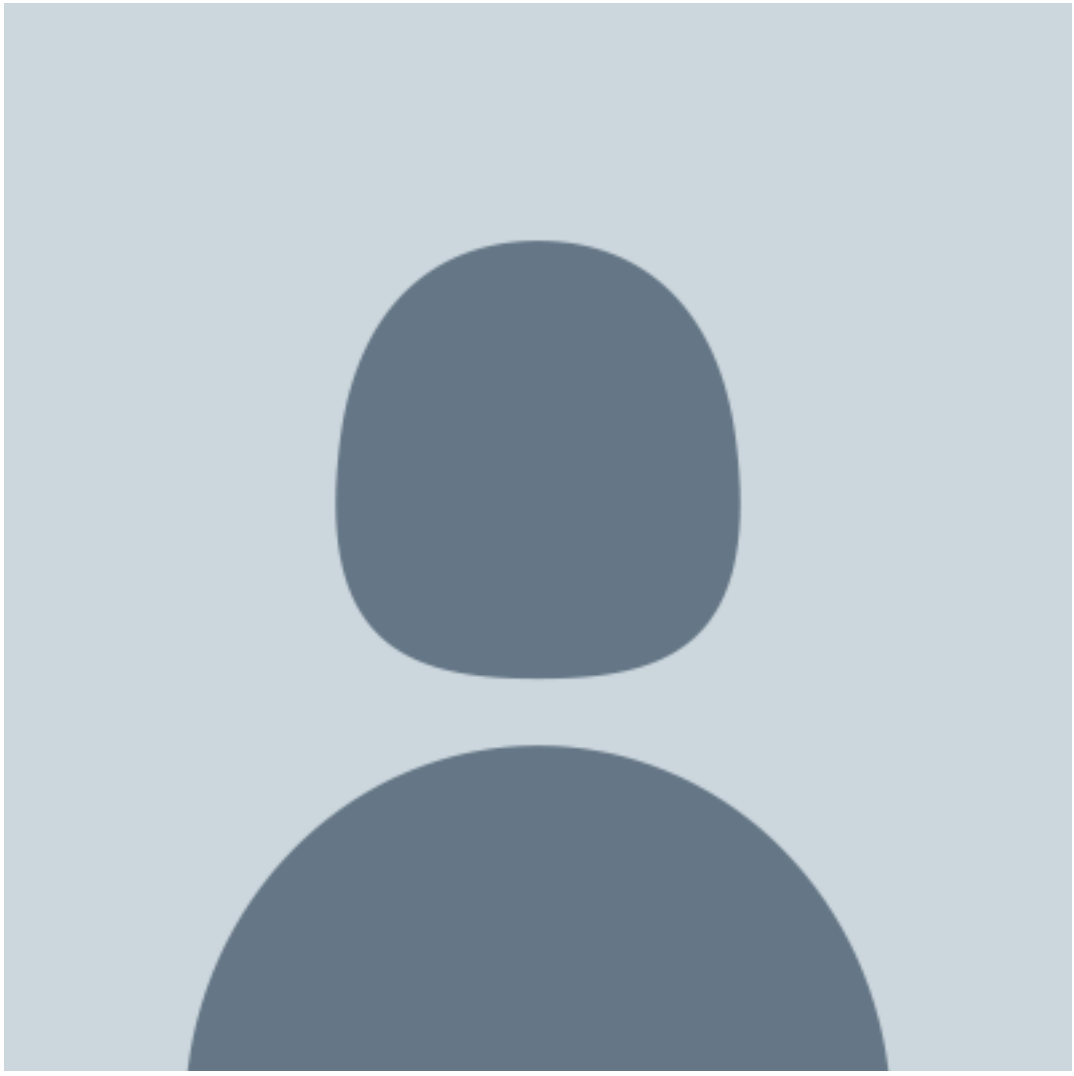
The enforceability of choice of law provisions in employment contracts is beyond the scope of this article, but employers may be able to reduce the number of relevant jurisdictions by incorporating a provision selecting the law of their primary place of business or state of incorporation.

See, e.g., *Hostetler v. Answerthink, Inc.*, 599 S.E.2d 271, 275 (Ga. Ct. App. 2004) (applying preclusion doctrines against the employer with regard to enforcement of an overbroad covenant).

See, e.g., *Laidlaw, Inc. v. Student Transp. of Am., Inc.*, 20 F. Supp. 2d 727, 765 (D.N.J. 1998) (refusing to blue-pencil non-competes where the employer failed to "tailor their restrictive covenants based on the confidential information to which the covenantor had access").

Labriola v. Pollard Grp., Inc., 834, 100 P.3d 791, 794 (Wash. 2004) (identifying potential sources of new consideration for a non-competition covenant including "increased wages, a promotion, a bonus, a fixed term of employment").

Maria Kalogredis



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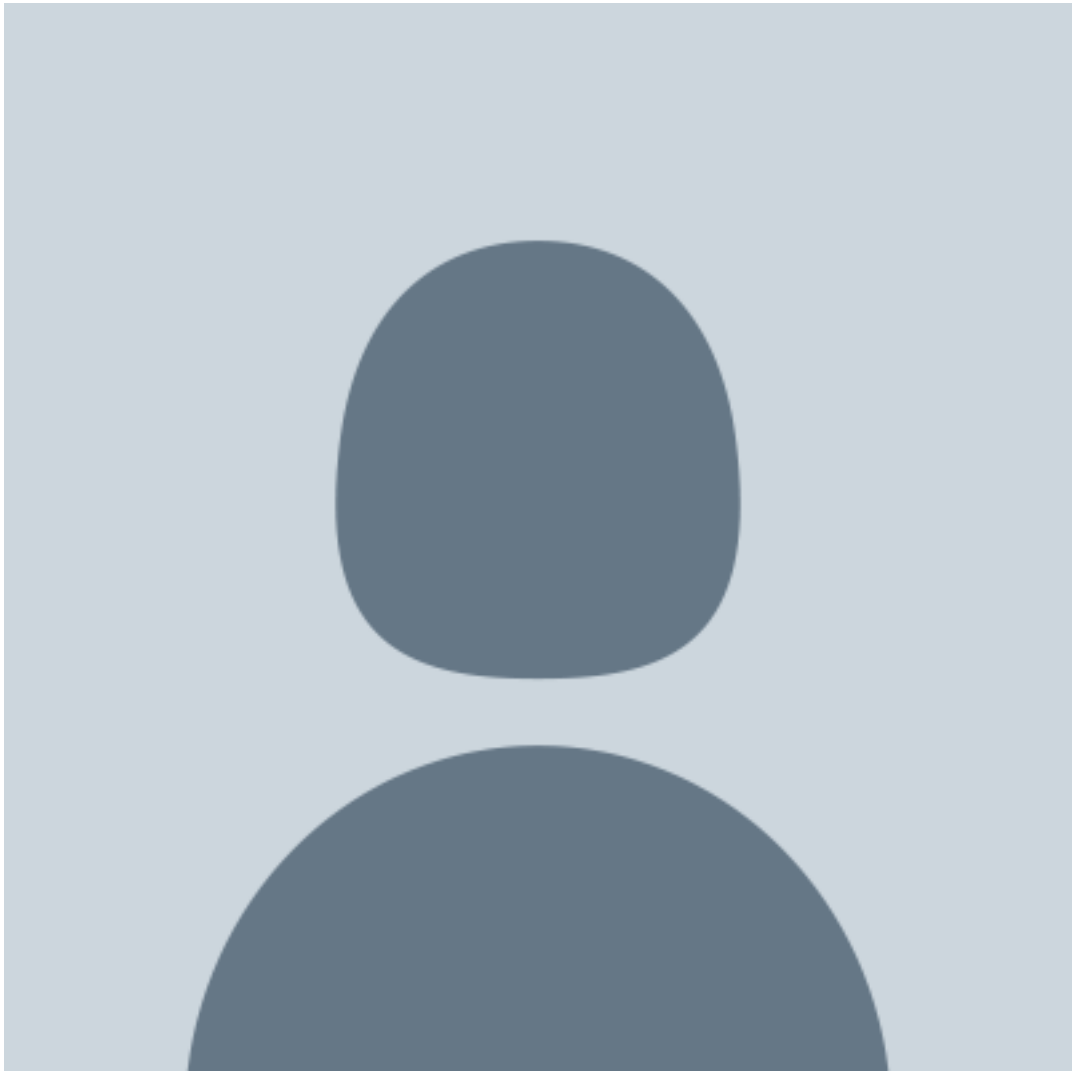

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