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Non-Compete Clauses and Professional Liability

By Andrea Schillaci and Christopher J. Kolber

As in life, communication is the key to successfully advising clients as to their rights and obligations under restrictive covenants.

Non-compete provisions have long been viewed by employers as reasonable and appropriate velvet handcuffs on departing employees and as an unfair burden on competition by the departing employees. The purpose of non-compete provisions is to guard valuable company assets, typically customers and clients which have often been developed over a long period of time and usually at great expense. These provisions are also used to protect proprietary trade secrets and the costs invested in training and developing employees. The search for the proper balance between these competing interests is frequently played out in the courtroom and increasingly in the legislatures and administrative arenas.

As attorneys representing professionals, we must be aware of our clients' contractual obligations to their employers as well as their fiduciary duties and duties of care to their clients. While admittedly rare, violations of non-compete agreements may have implications for professional liability. For instance, a professional employee who is sued by a former employer may find that their malpractice insurance does not cover legal fees or damages. Failure to advise a new employer of the existence of a non-compete agreement with a former employer may result in both the employee and new employer being sued. New employers may be sued for intentional interference with contract or even fraud. Former employers may also seek punitive damages.

Enforceability of Non-Compete Provisions

In recent years, the enforceability of non-compete agreements has been challenged and is in flux. States across the country continue to propose and pass restrictions that limit or eliminate an employer's ability to enforce a non-compete agreement on employees. Each state has been able to take a unique approach that fits their needs. Soon, however, that may not be the case. There has been pressure federally to pass regulations banning non-compete agreements. Most notably, the Federal Trade Commission ("FTC") has a proposed rule banning nearly all non-compete agreements federally that is set to be voted on in April of 2024. As this vote draws near, states may no longer have the opportunity to uniquely tailor their approach to non-compete agreements to fit their needs.

Employers across the country have had to monitor certain legislation that may limit their ability and what they can put in an employee's contract. There has been a lot of uncertainty and a lot of change over the years. Certain industries, like accounting, insurance, and real estate may be impacted more than others while employees across all industries and at all levels may stand to benefit. The uncertainty of employers and ambiguity between states may come to an end soon, and rather than wondering what they can and cannot do, employers will need to pivot their thinking to figure out how to best protect their businesses without the use of non-compete agreements.

Leveling the Field

It is well established that non-compete agreements for lawyers are prohibited, as discussed in ABA Model Rules of Professional Conduct Rule 5.6. Employees in other professions, however, have not

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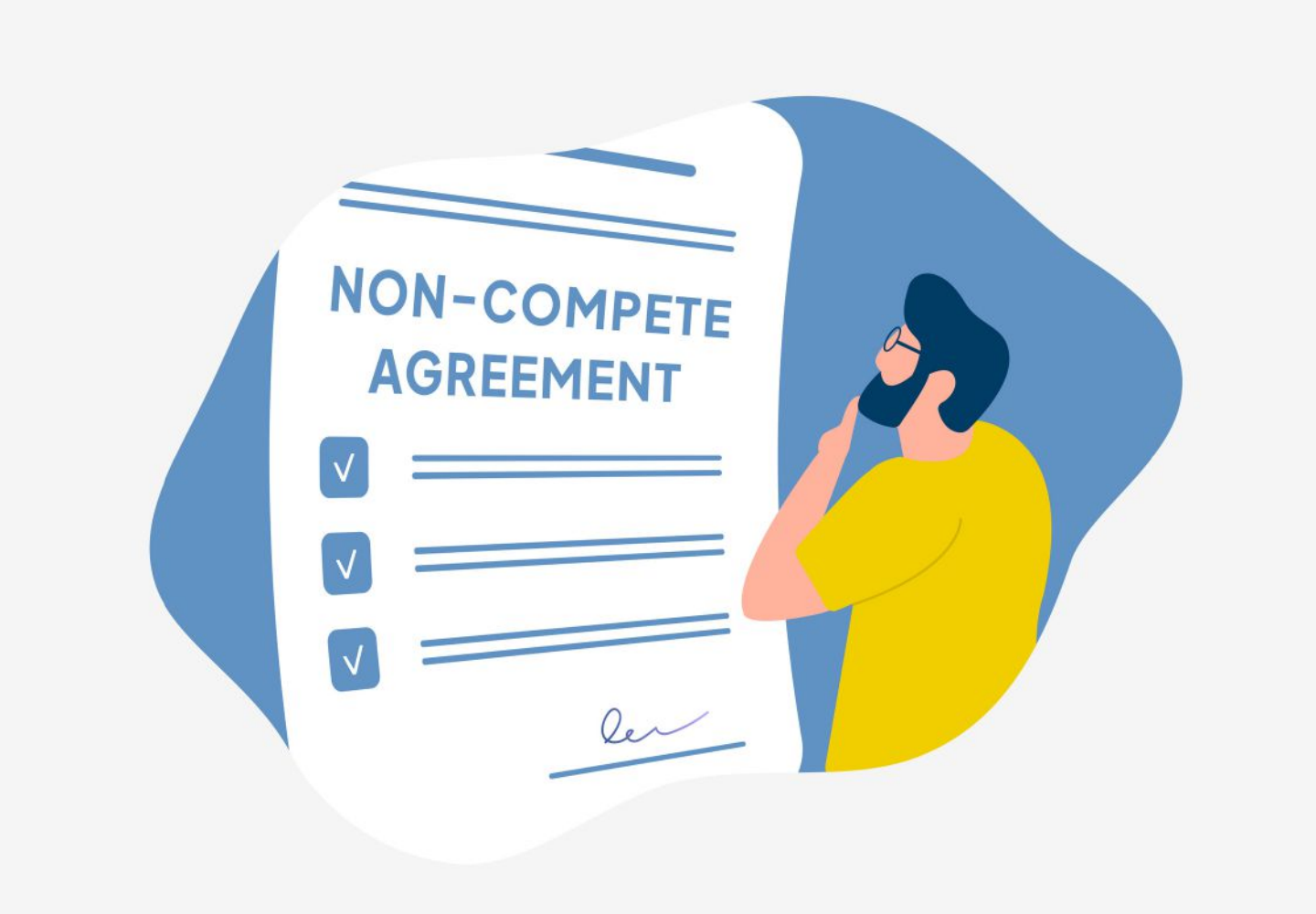

had the same flexibility. That experience is already changing across the country.

Originally, non-compete agreements were designed to protect trade secrets and were typically limited to high-ranking employees and licensed professionals, including accountants, real estate and insurance brokers, and health care professionals. These agreements have been increasingly impacting all types of workers however, including those in such disparate businesses as food service, yoga, construction, and retail establishments. Indeed, it is likely the expansion of non-compete provisions to hourly workers and more diverse areas of employment that has resulted in the cry for reform.

The Traditional Use of Non-Compete Provisions

When not abused and used in the correct industry and with the types of employees that non-compete agreements are intended to cover, these agreements are effective and useful for employers. There is little debate regarding the pro-business effects that non-compete agreements can have. Generally, when these agreements are litigated, questions about the reasonableness of the provision's term and/or geographic scope, and general enforceability are raised. In addition, defenses may include breach by the employer, which may serve to nullify enforceability of the non-compete.

In 2004, the United States Court of Appeals, Ninth Circuit found a non-compete agreement between Nike and a former executive (a director of sales) to be valid when the executive attempted to leave Nike to become the VP of US footwear sales and merchandising at Reebok, a direct competitor of Nike. *Nike, Inc. v. McCarthy,* 379 F.3d 576, 578 (C.A.9 (Or.), 2004). The court reasoned that the non-compete agreement was enforceable not due to the general skills in sales and product development that the executive possessed, but rather it was enforceable due to the substantial risk of the diversion of part of Nike's business as a result of the potential use of highly confidential information that the executive had and the threat of the use of that information harming Nike. *Id*. at 565-586.

The enforcement of a non-compete agreement for this reason makes sense. A high-ranking and powerful executive who departs a position for employment with a direct competitor poses a significant risk of her using this information to benefit a new company employer. This situation poses a real threat to the former employer. While the need to prevent this situation appears reasonable, compare this to a sandwich chain or coffee shop; where someone's general skills in the industry are what is being restricted, without the threat of diversion of business away from the sandwich or coffee shop.

New York courts have routinely held that as a part of a non-compete agreement, an employer has a legitimate interest in protecting the goodwill and relationships that the employer has developed. *Grp. Health Sols. Inc. v. Smith*, 32 Misc. 3d 1244(A), 938 N.Y.S.2d 227 (Sup. Ct. 2011). It is important, however, to determine whose goodwill is actually in question.

The Indiana Court of Appeals has held that a non-compete agreement between an accounting firm and former employee was valid, where the scope of the agreement was limited geographically and in time. *See Coffman v. Olson & Co., PC,* 906 N.E.2d 201 (Ind.App. 2009). The court held that the goodwill generated between a customer and a business is a legitimate protectable interest that can be the subject of a non-compete agreement, where the goodwill was used to perform work by the former employee with clients that were former customers at the former employer's firm. *Id*.

Many states and even the FTC have proposed broad based bans on non-compete agreements.

Still, the enforceability was never automatic. There have been instances where a non-compete agreement in a more traditional area is not enforced, even in the context of goodwill. Where there was no evidence of an insurance agent employee using any confidential trade secrets of the former employer to unfairly compete with him, an employment agreement not to compete was deemed to be unenforceable as the court held that the insurance agent's services were not unique or extraordinary, and thus not an interest that could be protected by a non-compete agreement. *See Riedman Corp. v. Gallager*, 48 A.D.3d 1188, 852 N.Y.S.2d 510 (2008). This dispute stemmed from an agreement where plaintiff paid to release defendant from his prior employment agreement and purchased certain accounts of defendant at his prior employer. *Id*. at 1188. While this agreement did have a provision preventing the defendant from soliciting or accepting insurance or bond business from plaintiff's customers for two years, this agreement did not consist of buying the goodwill of the defendant. *Id*. After leaving plaintiff's business, the defendant continued to serve customers who chose to follow him and acquired new clients through his own efforts. The court held that this was not a violation of the employment agreement because the defendant created and maintained the goodwill with his customers through his own efforts, and thus the goodwill of those clients was not acquired by the expenditure of plaintiff and therefore plaintiff has no legitimate interest in preventing defendant from competing for the business of those clients. *Id*. at 1189.

When viewing non-compete agreements in the above contexts, it is easy to see how employers can benefit from their enforcement. The key here is that these agreements have been able to be litigated to determine whether or not they protect a legitimate interest and if they are fair and enforceable, giving both the employer and employee an equal opportunity to plead their case. By letting employers and employees litigate these issues, certain parameters are able to be set that help to limit abuse and promote effectiveness of these agreements, benefiting employers in the proper context while not unduly restricting employees. If a proposed ban was passed, obviously employers will not be able to explain why their non-compete agreement is necessary, rather we will likely see employers in court arguing that some other sort of agreement or restriction should not be deemed a non-compete agreement under the given definition.

State Limitations

Due to the impact that non-compete agreements have had on workers and their expansive interpretation by employers, attempts have been made to limit or ban their use across many states and many industries. Many states and even the FTC have proposed broad based bans on non-compete agreements. When enacting these laws, most legislatures have tried to balance the promotion of flexibility for and competition by employees and the protection of the interests of employers.

Over half of the states in the United States have a ban or restriction on non-compete agreements, and that number continues to grow. California, North Dakota, and Oklahoma have enacted near total bans on non-compete agreements. Other states fall short of a total ban, for example Virginia (Code of Virginia § 40.1-28.7:8) has a ban on non-compete agreements for certain low-wage workers and Nevada (NRS § 613.195) has a ban on non-compete agreements for hourly workers. Other states, including Oregon (ORS § 653.295), have bans subject to conditions such as a threshold minimum gross salary and require notice of the agreement after termination. Additionally, many states have industry specific bans, providing similar protection as those afforded to attorneys, such as bans on non-compete agreements for physicians. In these instances, patient choice is given greater deference that protection for employers. States such as Massachusetts and Oregon have provisions known as "garden leave" which essentially allow the employer to compensate the worker during the period of the non-compete agreement as a form of consideration.

One state that has recently been struggling with this issue is New York. Governor Hochul recently vetoed New York Senate Bill S3100A. If passed, this bill would have prohibited employers from requiring, demanding, or accepting non-compete agreements and other certain restrictive covenants from a defined group of covered individuals. The reason for the veto was based on Governor Hochul's belief that a one-size-fits-all approach was not appropriate in New York due to its anti-competitive economic nature. Governor Hochul seems to prefer a non-compete agreement ban that protects lower- and middle-class individuals, while excluding individuals making over $250,000 from non-compete agreements. This approach is similar to the original intent of non-compete agreements, where higher up executives and earners are the individuals that have the non-compete restrictions. While New York has not yet passed a non-compete ban, new legislation is expected to be proposed again this year.

The lack of non-compete agreement bans has not prevented Attorneys General from trying to limit the use of non-competes in their respective states. One of the more notable examples of the abuse of non-compete agreements involves the fast-food sandwich chain, Jimmy John's. Jimmy John's was making their workers sign non-compete agreements which were very limiting and lasted two years. The Illinois Office of the Attorney General filed suit against Jimmy John's and the New York Office of the Attorney General entered into a settlement agreement with Jimmy John's after an investigation into its non-compete agreements. *People v. Jimmy John's Enterprises*, LLC, 2016 CH 07746 (Ill. Cir. Ct. Cook Cnty. June 8, 2016). In 2016, as a result of both the New York investigation and Illinois lawsuit, Jimmy John's agreed to rescind all of the non-compete agreements and cease use of them going forward. In a press release regarding the settlement, then New York Attorney General Schneiderman said, "non-compete agreements for low-wage workers are unconscionable." Similarly, a coffee shop in Washinton State called "Mercurys Coffee," entered into a settlement agreement and voided its non-compete agreements after the Washington State Attorney General brought suit when the coffee shop began enforcing its non-compete clause for its low-wage and hourly employees, alleging that it was an unfair method of competition. *State of Washington v. Mercurys Madness Inc. dba Mercurys Coffee Co.,* No. 19-2-28449-8 SEA (Sup. Ct. Wash. 2019).

Application of Non-Compete Agreements to Independent Contractors

In some states, non-compete agreements can even be enforced against independent contractors. If a proposed federal ban is passed it would have a positive impact on independent contractors in all different industries. The FTC is clear that the proposed rule will apply to independent contractors. Below are a few examples of how courts have analyzed non-compete agreements for independent contractors.

A Florida court granted a temporary injunction that enforced a non-compete agreement between employer and an independent contractor photographer when an independent contractor breached a non-compete agreement that protected a legitimate business interest of the former employer of the independent contractor, resulting in risk to the employer's goodwill and customer relationships. *See Picture It Sold Photography, LLC v. Bunkelman*, 287 So. 3d 699 (FL Dist. Ct. App. 2020). Here, the independent contractor was seeking to supplement his income by providing services for some of the employer's customers on the side. *Id*.

Similarly, an Ohio court held that a non-compete agreement between an employer and disc jockey was valid where disc jockey agreed not to compete with the company directly or indirectly within a 50-mile radius for two years after the termination of the agreement. *See SJA & Associates, Inc. v. Gilder*, 2002 WL 1500862 (Ohio App. 8 Dist. 2002). Since the disc jockey was compensated by the company, the court held that this was valid consideration to enforce the agreement. *Id*.

If banned either by the state or federally, independent contractors will have more flexibility regarding how and to whom they provide their services to as well. However, they still must be leery of non-solicitation agreements as the above example was still a violation of the independent contractor's non-solicitation agreement with employer and that would continue to be the case even under the proposed rule.

Non-compete agreements were never originally intended for low-wage and hourly workers, as a legitimate protectible business interest is hard to argue in these cases. If Jimmy John's was really concerned about employees using their trade secrets, there is robust trade secret law in the United States to protect them, without having to hinder competition and wages of workers with non-compete agreements. While these settlements were a step in the right direction, they were not the end of the road. As discussed, New York still has not succeeded in passing legislation on non-compete agreements. Due to what appears to be continued abuses, the federal government is trying to take the matter into its own hands.

Federal Limitations

There are ongoing attempts federally to restrict or limit non-compete agreements as well. In 2021, President Biden issued an "Executive Order on Promoting Competition in the American Economy" encouraging the FTC to ban or limit non-compete agreements in order to promote competition and increase wages for workers. Additionally, the General Counsel of the National Labor Relations Board (NLRB) stated in a memorandum in May of 2023 that overbroad non-compete agreements are unlawful because they chill the ability of employees to exercise their rights under the National Labor Relations Act (NLRA). In September, the NLRB filed a complaint against a medical clinic and spa, claiming that the overbroad non-compete agreement was a violation of the NLRA. *Harper Holdings, LLC, d/b/a Juvly Aesthetics*, (09-CA-300239, et al.).

In January of 2023, the FTC issued a notice of proposed rulemaking that if passed, would ban nearly all non-compete agreements. The vote for this proposed rule is set to happen in April of 2024. The FTC believes that about thirty million Americans are impacted by non-compete agreements and believes the proposed rule to ban non-compete agreements could increase workers' earnings by $250-$296 billion per year. In short, the proposed rule would provide that non-compete agreements are a method of unfair competition and rescind all existing non-compete agreements. The proposed rule, 16 CFR part 910, can be found on federalregister.gov. The proposed rule expands to independent contractors, interns, volunteers, apprentices, and sole proprietors providing a service to a client. The proposed rule has a limited exception pertaining to buyers and sellers of a business allowing a non-compete agreement where the party restricted is an owner, member, or partner holding at least 25 percent ownership interest in a business entity.

When determining the existence of a non-compete clause under the proposed rule, the FTC is not focused on the name of the clause, rather it is considering the substance of the clause and how it will impact the worker. The proposed rule's definition of a non-compete clause is "a contractual term between an employer and a worker that prevents the worker from seeking or accepting employment with a person, or operating a business, after the

conclusion of the worker's employment with the employer." Noticeably absent from this definition are certain types of non-disclosure and non-solicitation agreements, because they do not necessarily restrict employment and competition. However, if these provisions are too broad and begin to function as a non-compete clause, then they will not be valid. It is likely that this will be a large source of litigation in the future if this rule is passed.

Practical Impact of Banning Anti-Competition Agreements

Where non-compete agreements are still enforceable, it is prudent to ensure that they should be drafted in such a way as to permit enforcement. These provisions must be drafted and applied so that a reasonable interpretation would not find them to be unconscionable or to unfairly restrain competition. It is important to remember that one size does not fit all and what may be reasonable in one profession may not be similarly reasonable in another. It is best practice to consider which employees will be impacted and how it may hinder their prospects of future employment. For example, a low-wage worker in a company should not be subject to the same non-compete restrictions as a high earning CEO of the company. Employers must ensure they are protecting a legitimate interest of the business rather than just utilizing blanket provisions or, worse, punitive provisions. It is important to look at the traditional common law factors of non-competes such as time, scope, geographic location, and consideration.

As more and more states continue to pass legislation and with federal regulations being seemingly inevitable, some employers are preparing by opting to stop using non-compete agreements altogether. Other employers are reviewing their non-compete provisions to ensure the clauses are reasonable and not unduly restrictive.

It is inevitable that there will be a host of litigation pertaining to contractual provisions that are not necessarily called non-compete clauses but act as them. If an employee feels like they are being restricted by a non-disclosure or non-solicitation agreement in a way that prevents them from seeking or accepting employment, there likely will be litigation to determine whether the applicable provision, however named, really functions as a non-compete clause.

It remains to be seen how employers would react to and comply with a federal ban on non-compete agreements. As discussed, some states, like California, have passed a near total ban on non-compete agreements. However, this has not stopped all employers from continuing to put these clauses in employees' contracts, leading to the California Attorney General having to issue a reminder on oag.ca.gov that non-compete agreements are not enforceable. While such provisions are void and not enforceable, not every employee knows this, and they still can have a negative impact on workers' wages and competition. If the FTC does pass the federal ban, will this practice of employers continuing to put unenforceable non-compete provisions in their contracts continue? What will be the litigation consequences of an employer continuing to put unenforceable non-compete clauses in contracts, hoping to prey on an employee's potential lack of knowledge or understanding of the law?

Some companies have decided to be proactive and get ahead of the trend. For example, in 2022, Microsoft announced that it will not enforce non-compete agreements going forward in order to empower employee mobility. While applying to most employees, the non-compete agreements of certain Microsoft senior leadership will still be enforced. This type of initiative by Microsoft is more in tune with the true origin of non-compete agreements.

While non-compete agreements have recently arguably been enforced overbroadly, they do have a function when used properly to protect trade secrets, other confidential information, and the investments of employers. However, as the FTC points out, there is robust trade secret law to protect these interests. Additionally, true non-solicitation and non-disclosure agreements would still be valid under the proposed rule. It is still likely that in practice this will not be as simple as it appears, and it is inevitable that that this will play out in litigation.

It is also worth asking the question, is a full federal ban on non-compete agreements going too far? While there are many compelling reasons for a federal ban, as discussed above – there are scenarios where non-compete agreements make sense. It is clear that the consequences for low- and middle-wage workers will be positive, it remains to be seen what the consequences will be for accountants, real estate brokers, insurance brokers, and high-level executives, among others. There is the potential for a lot of litigation in the wake of a federal ban on non-competes. This will likely play out with regard to who certain goodwill belongs to and who certain clients belong to. However, this has not seemed to be an issue for law firms, as they have been operating in a world that has prohibited non-competes for years.

Some of the strongest opposition to the FTC's proposed rule comes from US Chamber of Commerce. The US Chamber of Commerce published comments that pertain to how the FTC essentially is using a one-size-fits-all approach, where individual circumstances are not considered, such as skill, responsibilities, access to certain information, and bargaining power. The US Chamber of Commerce also raises valid points describing how the FTC is failing to recognize the positive impact that non-compete agreements can have on businesses and how they can promote competitiveness, things that courts have recognized for many years. Id.

Is More Nuanced Regulation Needed?

There could be profound impacts felt by different states as a result of something that has typically been regulated by the states to now potentially being regulated federally. It is also important to recognize that each state has a unique economy and has unique needs, which is why states have had different approaches to dealing with non-competes, ranging from total bans to more nuanced bans. However, the FTC, under this proposed rule, will be treating each state and each economy identically, which could have some positive effects in one state while it is negatively impacting another state.

Most people can see the difference in how non-compete agreements are used properly and when they are abused. A worker making sandwiches at Jimmy John's should not be restricted from seeking any other employment while it makes sense

to restrict a high-ranking executive at Nike's ability to move to a competitor. It is likely that we will just see more litigation with regard to high-ranking executives and those alike to limit their ability to work, have mobility, or at least limit the harmful impact that move may have on his or her prior employer. These situations are different, and the FTC treating them the same may not be the most impactful solution. Abuse of non-compete agreements on low- and middle-wage workers may have clouded the original purpose of them, and as demonstrated above they are still useful when used properly in appropriate industries.

The overall attack on non-compete agreements across the country appears to be good news for all workers. To the contrary, while employers in certain industries will not feel the effects of a ban, there are many that will. Some employers will essentially have to reinvent the wheel when it comes to drafting contracts to protect their trade secrets, customer lists, and confidential information. It remains to be seen just what that will look like. One thing that is certain is that employers will test the limits to see just how broad a non-solicitation or non-disclosure agreement can be worded before a court will deem it a non-compete agreement prohibited by the proposed FTC rule.

While the end goal of a proposed ban on non-compete agreements is to protect employees, there comes a breaking point where employers will be harmed, which ultimately negatively impacts employees by having a chilling impact on the market. There certainly will be a benefit to a federal regulation, however, a total ban nationwide could have dire consequences. There is a clear need and desire for something to be done, but that something may not need to be a full federal ban, rather something that is more fact and industry specific could be more beneficial for employees, employers, and the market as a whole.

Practice Points

Employees who have non-compete agreements usually also have confidentiality and non-solicitation agreements. Employers who believe that former employees are acting in violation of these agreements, including non-compete agreements, often turn to litigation. Complaints often include allegations of breach of contract, fraud, misappropriation of confidential information, breach of fiduciary duty or unjust enrichment.

Professionals, including independent contractors, who are changing jobs must examine their employment agreements to determine what, if any, restraints exist. When restrictive covenants exist, they must be disclosed to prospective employers before accepting a new position.

It is often possible to seek release from an overly restrictive covenant and efforts to negotiate are advisable.

As in life, communication is the key to successfully advising clients as to their rights and obligations under restrictive covenants.