RESTRICTIVE COVENANTS IN EMPLOYMENT CONTRACTS: REGULATING EMPLOYEE SOLICITATION

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I. INTRODUCTION

Recently, Massachusetts considered legislation to regulate non-compete clauses in employment contracts.[1] The proponents of this legislation are considering this option because of the belief that non-compete clauses have been acting as a restraint on high tech start-ups.[2] The argument is that California, which has legislatively banned the enforcement of non-compete causes in employment contracts, has continued to be an incubator for high tech start ups while Massachusetts has seen its once vibrant technology industry fade. Non-compete clauses are seen as preventing high tech workers with innovative ideas from striking out on their own to initiate the next generation of innovative tech companies.[3] The proposed legislation will prevent employers from including non-compete clauses in the employment contracts of employees making less than $100,000 per year; require specific levels of non-salary compensation in order to make the non-compete clause binding; and severely limit the time and geographic scope of the clauses by presuming that any clause beyond the stated parameters in the legislation is unreasonable and therefore unenforceable under Massachusetts common law.[4] Finally, the legislation seeks to prevent employers from restraining their employees from being employed by competing firms, eliminating claims under the inevitable disclosure

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1. H. 1974, 186th Leg. (Mass. 2009); H. 1799, 186th Leg., (Mass. 2009).

2. *See* Christine M. O'Malley, Note, *Covenants Not to Compete in the Massachusetts Hi-Tech Industry: Assessing the Need for a Legislative Solution*, 79 B.U. L. REV. 1215, 1239 (1999); *see generally* Charles Tait Graves & James A. DiBoise, *Do Strict Trade Secret and Non-Competition Laws Obstruct Innovation?*, 1 ENTREPRENEURIAL BUS. L. J. 323 (2006).

3. Scott Kirsner, *Non-Compete Clauses May Be Making Us Non-Competitive*, THE BOSTON GLOBE (Jan. 19, 2009), http://www.boston.com/business/technology/articles/2009/01/19/non_compete_clauses_may_be_making_us_non_competitive.

4. H. 1974, 186th Leg. (Mass. 2009); H. 1799, 186th Leg. (Mass. 2009).

doctrine (which states that employees who are privy to trade secrets will inevitably disclose them to their new employer and therefore should be restrained from employment by a competitor).[5]

While this legislation may increase employee mobility, it does not address the problem of covenants not to solicit employees, which it specifically leaves unchanged. The failure to address the issue of non-solicitation of employee clauses is problematic for two reasons. First, it keeps the legislation from accomplishing its main goal of making Massachusetts competitive with the West Coast as an incubator for start-ups. Second, as employers realize they can no longer enforce non-competes, they may then try to restrain employee mobility by enforcing non-solicitation of employee clauses. As one commentator on the proposed Massachusetts legislation summarized the situation, "[o]n the West Coast, talent is more fluid. Good people gravitate toward good ideas and bring along other good people with whom they have worked in the past. This greatly increases a company's chances of success."[6]

Employment mobility is an increasingly important public policy issue; with the American economy in transition, the average employee expects to have both multiple employers and multiple career tracks. Legislatures can attempt to increase business activity in their respective states by encouraging innovation through increased employee mobility, or they can attempt to limit employee mobility to appear business friendly. The Georgia Legislature opted for a 'business friendly' solution placing an amendment to the Georgia constitution on the November 2010 ballot to help clarify restrictive covenants and limit employee mobility. The amendment passed in a "a landslide victory," garnering 68% of the vote.[7] The constitutional amendment ratified previously approved legislation[8] designed to constrain competition and employee mobility.[9] Georgia hopes that the new law will help attract existing businesses from other states.[10] In the northeast, states have historically relied on technical innovation to increase business activity.

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5. For additional information on the inevitable disclosure doctrine, see Matthew K. Miller, *Inevitable Disclosure Where No Non-Competition Agreement Exists: Additional Guidance Needed*, 6 B.U. J. SCI. & TECH. L. 240 (2000).

6. Kirsner, *supra* note 3.

7. Joanne Deschenaux, *New Day Dawns for Georgia Noncompete Law*, SOC'Y FOR HUM. RESOURCE MGMT. (NOV. 5, 2010), http://www.shrm.org/LegalIssues/StateandLocalResources/Pages/NewDayDawns.aspx.

8. H.B. 173, 150th Leg. (Ga. 2009).

9. A. Robert Fischer, Conrad S. Kee, C. Todd Vand Dyke, Jackson Lewis LLP, *Georgia Passes New Law That May Enhance Enforceability of Noncompete Agreements*, SOC'Y FOR HUM. RESOURCE MGMT. (May 11, 2009), http://www.shrm.org/LegalIssues/StateandLocalResources/Pages/GeorgiaEnforceabilityofNoncompete.aspx.

10. Diane Cadrain, *Lawmakers Examine Restrictive Covenants in Employment Contracts*, SOC'Y FOR HUM. RESOURCE MGMT. (Feb. 11, 2009), http://www.shrm.org/LegalIssues/StateandLocalResources/Pages/LawmakersExamineRestrictiveCovenantsinEmploymentContracts.aspx.

Accordingly, the proposed Massachusetts legislation was designed to increase employee mobility and encourage technical innovation.

Non-solicitation of employee clauses have rarely been enforced in the past and there is no Massachusetts case law on the subject. However, such clauses have been litigated in California (where the enforcement of non-competes has been barred by legislation) as well as several other states. The case law on both non-compete clauses and non-solicitation of employee clauses has sought to balance the legitimate business needs of the employer against the employee's right to seek the most advantageous employment situation.

This Article will provide a brief introduction to restrictive covenants in employment contracts; outline the reasons that non-solicitation of employee clauses have been included in employment contracts; and review several significant court decisions on non-solicitation of employee clauses. It concludes that if other states consider legislation that affects restrictive covenants they should include non-solicitation of employee clauses in both the discussion of non-compete clauses and any other legislative initiatives that address employee mobility.

II. RESTRICTIVE COVENANTS IN EMPLOYMENT CONTRACTS

The introduction of the guild system in Europe was probably the first organized effort by businesses to limit their competition, keep their employees from seeking other opportunities, and protect their trade secrets from disclosure. As the industrial age progressed, the guilds gave way to a more modern system of commerce, but the instinctive desire to protect a business from competition, loss of trade secrets, and the loss of employees remained. In the modern age businesses have used restrictive employment covenants to achieve these goals. Courts have been asked to balance the needs of the modern industrial society, employers and employees when interpreting these contacts; and legislatures have wrestled with how to preserve the advantages of competition, provide the opportunity for workers to sell their labor to their best advantage, and still appear business friendly.

"[R]estrictive covenants generally span four different areas: (1) general non-competition; (2) customer (or client) non-solicitation; (3) employee non-solicitation; and (4) non-disclosure."[11] When interpreting these covenants, courts will enforce them if they are reasonable. "[R]easonableness is measured by its hardship to the employee, its effect upon the general public, and the reasonableness of the time, territory, and activity restrictions."[12] In addition, courts will consider whether the employer has a

11. Kenneth J. Vanko, *"You're Fired! And Don't Forget Your Non-Compete...": The Enforceability of Restrictive Covenants in Involuntary Discharge Cases*, 1 DEPAUL BUS. & COM. L. J. 1, 2 (2002).

12. Arpac Corp. v. Murray, 589 N.E.2d 640, 649 (Ill. App. 1992).

"legitimate business interest" and if the covenants are drawn narrowly enough to protect that interest while putting the least burden on the employee and the general public, which as a matter of public policy has an interest in free competition. Courts will also consider whether the restrictive covenant seeks to limit the former employee in specific "activities" (described as an activity covenant) or seeks to eliminate competition.[13] Customer non-solicitation and non-disclosure covenants are generally viewed as activity covenants and it is easier for the courts to find that businesses have a legitimate business interest in their customer lists and trade secrets, so courts are more likely to uphold those restrictive covenants.

Non-competition clauses are much more likely to be viewed as limiting competition, so courts are reluctant to enforce them. However, the usual method of enforcing non-competition clauses is through injunctive relief, and courts have wide discretion in both issuing injunctive relief and modifying non-competition clauses so that they meet the reasonableness standard necessary to be enforceable. The uncertainty caused by wide judicial discretion in enforcement, combined with the high cost of litigation, has a chilling effect on employers who seek to hire a new employee who has signed a non-competition agreement with his or her former employer.[14] While there is a substantial body of case law and commentary on non-competition clauses, an extensive discussion of these is beyond the scope of this article.[15] However, it is worth noting that non-competition covenants are becoming both less popular and less enforceable as both courts and legislatures seek to narrow their scope.[16]

Although they have not been extensively litigated, non-solicitation of employee clauses have been viewed both as activity covenants[17] and as generally anti-competitive.[18] Based on the experience in California, which has seen an increase in litigation around non-solicitation of employee cases since it restricted non-competition covenants, it seems likely that as non-competition clauses continue to fall out of favor, employers will rely more on non-solicitation of employee clauses to limit employee mobility.

III. REASONS TO PROHIBIT SOLICITATION OF EMPLOYEES

Firms hire away the employees of other firms for many reasons. To find a potential employee with both skills and experience, one would look to

13. *Id.*

14. *See* Thomas M. Hogan, *Uncertainty in the Employment Context: Which Types of Restrictive Covenants are Enforceable?*, 80 ST. JOHN'S L. REV. 429, 453 (2006).

15. *See* David A. Goodof, *Massachusetts Covenants Not to Compete in an Era of Employment Uncertainty*, 38 BUS. L. REV. 25, 26 (2005); Vanko, *supra* note 11; M. Scott McDonald, *Noncompete Contracts: Understanding the Costs of Unpredictability*, 10 TEX. WESLEYAN L. REV. 137 (2003).

16. Griffin Toronjo Pivateau, *Putting the Blue Pencil Down: An Argument for Specificity in Noncompete Agreements*, 86 NEB. L. REV. 672, 673 (2008).

17. *See Arpac*, 589 N.E.2d at 649.

18. Schmersahl v. McHugh, 28 S.W.3d 345, 349 (Mo. Ct. App. 2000).

other firms, often in the same line of business. Hiring away individual employees with the knowledge, skills, and experience a firm needs is a common business practice. Yet it is a practice that is limited to allow a former employer to protect trade secrets and confidentiality, even if there is no employment contract. Common law causes of action for disclosure of trade secrets and confidential information are longstanding and well known features of the business environment. But when firms hire away two or more employees from another firm in a short time span, it is often considered an attack on the other firm's human capital.[19] Such attacks are characterized in a number of ways; the terms "poaching," "pirating," or "raiding" have all been used to describe the process. For the purposes of this article, it will be referred to as "corporate raiding."

Corporate raiding is considerably more problematic for firms than losing a single employee; it can disrupt business plans, significantly delay projects and products, weaken the competitive abilities of the firm under "attack," and ultimately cost a great deal of time and money.[20] Corporate raiding is especially popular in the financial sector and high tech industries, but it can happen in any business environment from publishing[21] to shrink wrap packaging[22] to car sales[23] to hotels.[24] Where it is designed specifically to weaken a competitor, courts will consider corporate raiding unfair competition. When one employee arranges for a group of fellow employees to all leave at the same time it is often considered a breach of fiduciary duty[25] or a breach of the duty of good faith.[26] When there is no employment contract, firms can bring common law claims for breach of fiduciary duty and/or breach of the duty of loyalty as well as anti-trust claims for unfair competition, but such suits are expensive and time consuming.[27] Even if a firm "wins" it can be irreparably harmed.[28]

Firms raid other companies for employees because it is much easier to assemble a workforce if you simply move a whole collection of skilled employees into place, and it is much easier to hire people whose skills and abilities are known and who can work together comfortably. It is also easier to entice away customers and lines of business when you take a group of a competitor's employees. When a firm is damaged in this way, it is much more likely to respond by suing, although that may not be the best course of

19. Timothy M. Gardner, *Interfirm Competition for Human Resources: Evidence from the Software Industry*, 48 ACAD. MGMT. J. 237, 238 (2005).

20. *See* Loral Corp. v. Moyes, 219 Cal. Rptr. 836, 840 (Ct. App. 1985).

21. Bancroft-Whitney Co. v. Glen, 411 P.2d 921, 924 (Cal. 1966).

22. *Arpac*, 589 N.E.2d at 644.

23. Balasco v. Gulf Auto Holding, 707 So. 2d 858, 859 (Fla. Dist. Ct. App. 1998).

24. Michael S. Rosenwald, *Instead of Zen Dens, Starwood Builds an Espionage Case Against Hilton*, WASH. POST, June 13, 2009, at A10.

25. *Bancroft-Whitney*, 411 P.2d at 934.

26. Jim Middlemiss, *Ruling to Affect Brokerages; Court Finds for RBC*, FIN. POST, Oct. 10, 2008, at FP2.

27. *Bancroft-Whitney*, 411 P.2d at 936.

28. *Loral Corp.*, 219 Cal. Rptr. 836.

action. In most instances, a firm would prefer to avoid the corporate raid and subsequent litigation by simply keeping its employees.

Firms can take a number of prophylactic actions in order to avoid corporate raids: they can ensure that their wages and working conditions are competitive; require their employees to notify them when they are discussing employment offers with specific competitors; and include non-solicitation of employee clauses in employment contracts. While none of these actions is guaranteed to work, firms are increasingly relying on non-solicitation of employee clauses because they are more likely to discourage solicitation of employees (the present employee might not be familiar with common law causes of action but they have hopefully read their contracts). It is often possible to seek injunctive relief that will allow the firm time to recover and perhaps keep their customers and lines of business.[29] Firms may also be better able to obtain damage awards. However, courts have not been consistent in interpreting these clauses and firms might be better off if they focus their energies on non-solicitation of customers and protection of their trade secrets and confidential information. Restrictive covenants in employment contracts that seek to protect trade secrets and confidential information are easier to enforce, while holding on to employees who wish to leave is likely to have negative consequences for the organization.

IV. SIGNIFICANT COURT DECISIONS

As noted above, there has not been a great deal of reported litigation on non-solicitation of employee clauses in employment contracts. Those cases that have been decided tend to focus on whether there was a legitimate business interest to protect and whether the contract was sufficiently narrow in scope to meet the reasonableness standard used to evaluate restrictive covenants. Only one court has rejected covenants not to solicit employees as a matter of public policy.

In *Schmersahl v. McHugh* the Missouri Court of Appeals was presented with a case in which Tim McHugh, the former employee of an accounting firm, had signed an employment contract with restrictive covenants that covered a three year period, including a non-solicitation of employees clause. [30] McHugh mentioned to a former colleague that there was an opening at his new firm during a lunch meeting eighteen months after he left.[31] His old firm, Schmersahl, Treloar & Co., sued seeking to recover liquidated and actual damages for breach "of a covenant not to 'solicit, persuade, induce, or encourage' employer's employees to terminate their

29. *See* Stephan Gandel, *Investment Banks Seek to Lock Up Top Staffers*, CRAIN'S N.Y. BUS., Apr. 03, 2000, at p.18; Peter Brown, *Atmel Wins Legal Round in Illegal Solicitation Suit*, ELECTRONIC NEWS, Apr. 06, 1998, at p.20.

30. *Schmersahl*, 28 S.W.3d at 347.

31. *Id.*

employment."[32] The Missouri court found that "the covenant restrains trade and does not fall within the class of restrictive covenants which may be enforced in Missouri because it is not directed to the protection of trade secrets or customer contacts."[33] The court further held that "an employer's interest in protecting the stability of its at-will workforce is not one of the interests that may be protected by a restrictive covenant in Missouri."[34] It did observe, however, that if soliciting the employees was designed to either "destroy another's business" or "misappropriate the employer's trade secrets" then the conduct would be "culpable."[35]

In contrast, in *ARPAC v. Murray* the Illinois Appellate Court took the position that maintaining a stable workforce was a legitimate business interest and therefore upheld a restrictive covenant that prevented Murray from "inducing" ARPAC's employees to quit.[36] The court looked at Murray's phone records, and noted that the records indicated that Murray had not called the two workers that joined his new firm before he left ARPAC but then called them repeatedly after he left in what the court characterized as a "flurry of activity."[37] While the court struck down the covenant not to compete as "overly broad,"[38] they affirmed the lower court's order enforcing non-solicitation clauses covering ARPAC's employees and customers.

In *Hay v. Bassick* the Federal District Court looked at two different employment contracts that had been entered into by former employees who were being sued for multiple breaches of restrictive covenants.[39] The specific non-solicitation of employees language that the court examined sought to prevent one of the defendants from "soliciting or otherwise directly attempting to induce any employee of the Hay Group, Inc. or its affiliates to terminate his or her employment."[40] Since the court could find no legitimate business interest that was being protected by the restrictive covenant they held that "this restriction is a blanket prohibition on soliciting any Hay employee, and as such is unenforceable."[41] It is unclear if they would have enforced the restriction even if it had been tied to a legitimate business interest because it was so broad that it might have been considered unreasonable in scope.

Other courts that analyzed restrictive covenants not to solicit employees by looking for a legitimate business interest have found that investments in

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32. *Id.* at 348.
33. *Id.*
34. *Id.* at 351.
35. *Id.*
36. *Arpac*, 589 N.E.2d at 650.
37. *Id.*
38. *Id.* at 652.
39. Hay Group Inc. v. Bassick, No. 02 C 8194, 2005 U.S. Dist. Lexis 22095, at *2-3 (N.D. Ill., Mar. 24, 2008).
40. *Id.* at *15.
41. *Id.* at *22.

"specialized training,"[42] confidential information,[43] and trade secrets[44] are legitimate business interests. Courts generally will not enforce a restriction if they cannot find that the covenant is protecting a legitimate business interest. Several courts have also discussed whether or not information about employees' salaries and skills are trade secrets without reaching a direct holding on the issue.[45]

In *Loral Corp v. Moyes*, a leading California case, the California Court of Appeal identified trade secrets as a legitimate business interest in dicta, but it based its holding in the case on a narrow interpretation of how the restrictive covenant would be applied. Robert Moyes was President of a Loral subsidiary who signed a termination agreement which provided for post employment compensation in return for Moyes promise not to "disrupt, damage, impair or interfere with the business . . . by . . . raiding its employees."[46] Immediately after he left his position with the Loral subsidiary he went to work for a competitor and began interviewing and hiring away key Loral employees. Loral sued arguing that Moyes had breached the separation agreement. The trial court entered a non-suit after opening arguments, holding that the separation agreement was null and void because it constituted a restraint of trade under California Business and Professional Code section 16600. The California Court of Appeal reversed the trial court holding that restrictive covenants not to solicit the employees of a former employer only bar solicitation. The employees of the former firm are "not hampered from seeking employment" with the new firm; they are simply losing the option of "being contacted first," and therefore there is very little restraint on employee mobility.[47] The employee who leaves first does not experience "significant restraint on his engaging in his profession, trade or business;" he has simply given up the opportunity to solicit the employees from his former firm.[48] Loral is often cited for holding that a covenant not to solicit employees of a former employer only bars solicitation; it does not actually prevent the employee from being hired.

Finally, many of the court decisions cite *Lane v. Taylor* in support of the proposition that a one year contract provision preventing the "pirating" of employees was not overly broad and was reasonable as to the length of the restriction.[49] The Lane case overturned a lower court's granting of summary judgment and held that "a jury question was presented concerning the legitimacy of the need to maintain the confidentiality of the information in

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42. *See Balasco*, 707 So. 2d at 859.

43. *See* Greystone Staffing v. Goehringer, No. 13906-06 (N.Y. App. Div. 2006); Unisys v. Entex Info. Serv., 45 Pa. D. & C. 4th 405 (C.C.P. Montgomery 2000).

44. *Bancroft-Whitney*, 411 P.2d at 939.

45. *Id.* at 941; *Loral Corp.*, 219 Cal. Rptr. at 843.

46. *Loral Corp.*, 219 Cal.Rptr. at 840.

47. *Id.* at 844.

48. *Id.* at 843.

49. Lane Co. v. Taylor, 330 S.E.2d 112 (Ga. Ct. App. 1985).

question."[50]

V. ANALYSIS

While no state has decided enough cases that specifically deal with non-solicitation of employee contract provisions to create a cohesive body of law in the area, several trends have emerged. When facing this issue, courts seem to apply a balancing test that compares the need for businesses to protect their legitimate interests with both the burden placed on the former employees and the perceived restraint on trade. Courts borrow the reasonableness standards normally applied to restrictive covenants of time, territory and activity. However, these trends are not sufficiently well developed to allow attorneys representing businesses to be confident about how the court in any state (except Missouri) will decide on the enforceability of restrictive covenants not to solicit employees if it is challenged.

Courts differ on whether non-solicitation of employee clauses are minor activity restrictions and generally reasonable,[51] or broader restraints on trade and unreasonable.[52] There is also uncertainty about what a court would consider a legitimate business interest. That uncertainty about what constitutes a legitimate business interest will only increase as information about employees, customers and business practices become more widely available on the internet. *Greystone Staffing v. Goehringer* illustrates this premise; the court observed, "customer information is not considered confidential if it is readily obtainable through public sources."[53] Will firms whose employees post their resumes online in order to "test the waters" have the confidentiality of their employee identities, skills, and salaries destroyed because the information is readily obtainable?

There may also be ambiguity about what constitutes solicitation. Will courts that only seek to limit "solicitation" find that placing information on a Facebook page about the benefits of a new employer to be solicitation of their former employer's workers? In *Unisys v. Entex*, the court found that sending an email to fellow employees about a new job offer "which will afford me a financial opportunity which cannot be found at Unisys"[54] and encouraging those employees to "please stay in touch" constituted solicitation, but Facebook is arguably a more passive activity. Uncertainty often results in litigation, and litigation in this area is expensive. In a Colorado case that dealt with the applications for preliminary injunctions, the winning party received $75,000 in attorney's fees.[55]

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50. *Id.* at 116.
51. *Loral Corp.*, 219 Cal. Rptr. at 843-44.
52. *Hay Group, Inc.*, 2005 U.S. Dist. LEXIS 22095.
53. *Greystone*, at *3.
54. *Unisys*, 45 Pa. D. & C. 4th at 408.
55. Atmel Corp. v. Vitesse Semiconductor Corp., 160 P.3d 347 (Colo. App. 2007).

However, firms are going to continue to try to retain their employees through restrictive covenants because replacing employees that have been raided by a competitor is so expensive. In Loral, the plaintiff estimated that it had spent over $400,000 on recruiting new employees to replace those who had left.[56] The plaintiff did not offer information about costs beyond recruitment such as training costs for new employees or lost productivity while they were replacing the employees, so this estimate may be conservative. The desire to try to protect or preserve both human capital and the investment in training will provide strong motivation to seek legal advice on available options and covenants not to solicit employees will remain an obvious option. The covenants may not be enforceable in all courts but they will provide at the very least, a chilling effect that may slow the loss of employees because the potential costs of the litigation are so high.

VI. CONCLUSION

If courts and legislatures continue to limit the applicability and usefulness of covenants not to compete, there will be more reliance on restrictive covenants not to solicit employees and there will be more courts that focus their decisions on restrictive covenants not to solicit employees. These covenants may not be enforceable, but they will probably have a chilling effect on corporate raids of employees and they will adversely affect employee mobility. This article proposes that it would be better for legislatures considering restrictions on competition to include non-solicitation of employee clauses in their considerations because limitations placed on non-competition clauses by either the courts or legislatures seem to increase reliance on non-solicitation of employee restraints and any restrictive covenant that restricts employee mobility raises public policy issues that the legislative branch should consider.

Attorneys who are trying to help firms limit the loss of employees to corporate raids should also consider advising them to consider alternate solutions. Microsoft has apparently tried to limit employee loss by requiring their employees to notify them when they are talking to another company about employment opportunities.[57] Requiring employees to disclose their negotiations for new employment would also have a chilling effect that would slow down the loss of employees to other firms and would give the firm being targeted for a raid an opportunity to compete for the employee. Attorneys should also focus on emphasizing the protection of trade secrets and confidential information in employment contracts, both because courts will more readily enforce non-disclosure covenants and because non-disclosure covenants will provide the legitimate business interest necessary

56. *Loral Corp.*, 219 Cal. Rptr. at 840.

57. Rebecca Buckman, *E-Business: New Web Software Start-Up Draws Microsoft Workers – and Its Ire*, WALL ST. J., Sep. 11, 2000, at B1.

for enforcement of customer non-solicitation clauses.

While there are no easy solutions for companies who are trying to retain employees, restrictive covenants not to solicit employees will remain a useful option for business lawyers. If state legislatures want to regulate the use restrictive covenants in order to improve employee mobility and encourage entrepreneurial activity, they will need to consider both covenants not to compete and covenants not to solicit employees.