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Noncompete Jurisprudence During The Recession

Law360, New York (February 03, 2010) -- Discouraging anecdotes about unexpected layoffs and endless job searches are now commonplace on every train ride, in every grocery store line and at every dining table. Unfortunately, public pessimism about the economy and its stranglehold on the job market is inevitable given the recent data.

Through November 2009, the national unemployment rate was 10 percent and, although it has dipped recently, there are few signs of a real recovery.[1] Indeed, as of Sept. 30, 2009, there were only 2.5 million job openings nationwide, 48 percent fewer than the most recent peak in June 2007.[2]

The number of layoffs and other involuntary separations has declined somewhat in recent months, but the overall hire rate has not improved.[3] On the contrary, over the 12 months ending in September, the nation suffered a net employment loss of 5.2 million jobs.[4] In a word, the job market is stagnant.

Against this backdrop, one might expect that the economy's role in cases that seek to enjoin employment pursuant to a noncompetition agreement or other restrictive covenant would have become more prominent over the past year. Remarkably, however, the economy appears to have had no impact whatsoever on noncompete jurisprudence.

Standard noncompetition agreements provide that an employee may not work for a competitor of his employer for a certain period of time within a certain geographic area following the termination of his employment.

Accordingly, in the typical noncompete enforcement case, the employer has sued the employee to prevent him from accepting a job that falls within the scope of such an agreement. At their core, these cases are essentially breach of contract actions in which an injunction, rather than damages, is the primary means of relief.

Noncompete agreements, however, stand in considerable tension with the oft-cited public policy favoring the free flow of labor and ideas.[5] As a result, they can be more difficult to enforce than other types of contractual agreements.

In some states, most notably California, noncompetes are of limited use as a matter of public policy.[6] And in states where they are enforceable, such as New York and Pennsylvania, they are generally enforced only if they are found to be "reasonable" under the facts and circumstances of the particular case.[7]

An employer fighting to protect its rights under such an agreement is at something of a disadvantage from the outset. As in any other breach of contract case, the employer must prove that an enforceable agreement exists and that the employee's actions would be a breach of its terms.

Additionally, however — and in stark contrast to most other breach of contract cases — the employer must also convince the court that enforcement of the agreement would be reasonable; in effect, that it would be just and proper under the circumstances.[8] It is with regard to this final piece of the employer's burden that the current state of the economy could be extraordinarily compelling.

In evaluating the reasonableness of a noncompetition agreement, courts must balance and attempt to reconcile directly competing interests — the employer's interests in protecting its hard-earned market share and the employee's interest in pursuing a better opportunity for career advancement and personal security.

But everyone is a little skittish during a recession and these interests are consequently heightened. Indeed, employers may be both over-protective of their own intellectual property and more aggressive in their efforts to outpace their competitors, while employees inevitably question their job security and may be easily seduced by the prospect of greener pastures. This kind of anxiety adds innumerable new factors to an already difficult equation.

To be sure, an employee challenging the enforceability of a noncompete could make a compelling argument that the recession cuts against the practicality of the employer's interests and adds to the harm the employee would suffer from enforcement.

For one thing, the job market is undoubtedly teeming with capable replacements for positions in every industry and at all levels of experience.

Furthermore, public policy would presumably be in favor of reducing barriers to employment in this economy,[9] particularly if confidentiality and nonsolicitation provisions are in place to independently safeguard trade secrets and other confidential information and to prevent the departing employee from usurping his employer's book of business.

Finally, the recession would also seem to provide a persuasive basis to challenge the necessity for and impact of a noncompetition agreement's substantive, geographic and temporal scope since broader terms mean greater expenses and fewer options for the restricted employee. Then again, the recession could provide an equal measure of support for the employer.

Due to decreased budgets for all types of business spending, competition is fiercer than ever before. Quality and reputation are no longer enough. Businesses that survive in this economic climate must do more than just offer indispensable products and services to their customers; they must also do so at the lowest sustainable price point, which means that they must cut costs wherever possible.

But innovation is not often compatible with frugality and desperation can lead to unscrupulous opportunism. Arguably, therefore, public policy would favor increased judicial vigilance in protecting the rights of employers under noncompetition agreements.

Regardless of how you look at the issue, the economic downturn and anemic job market would seem to be increasingly appropriate considerations for any judge charged with determining whether to enforce a noncompetition agreement, both at the preliminary injunction stage and on the merits.

Indeed, even in better times, the state of the economy is plainly relevant to the likelihood of irreparable harm to the employer, the balance of the hardships, the public interests and the likelihood of the employer's success on the merits, particularly with respect to the restriction's reasonableness.

Nonetheless, the economy, however, has rarely even been mentioned in recent decisions involving the enforceability of noncompetition agreements, and when it has, it has had no appreciable impact on the outcome of the dispute.

For example, in Naden v. Numerex Corp.,[10] the court considered a motion for a preliminary injunction filed by three former executives of Numerex Corp. to prohibit Numerex from enforcing their noncompetition agreements.

Numerex had purchased the assets of the plaintiffs' satellite tracking device business and then entered into employment agreements with them pursuant to which they were to continue to run the company. The employment agreements included provisions that broadly prohibited them from working in the same industry for a certain period of time following any termination of their employment with Numerex.

Each of the plaintiffs resigned shortly after the deal closed, secured offers of employment from other companies in the industry, and then brought suit to prospectively enjoin Numerex from enforcing their noncompetes.

They argued that enforcement would cause them irreparable harm because they would lose their employment offers and would have difficulty returning to the industry due to the rapid pace of technological change and the potential obsolescence of the particular technology in which they had expertise.[11]

In rejecting these arguments, the court cited the current state of the economy as a reason not to attempt a new business venture and as a basis for disputing the plaintiffs' argument about the pace of technological change.[12]

Ultimately, however, the court's decision rested predominantly on the fact that the plaintiffs failed to provide any concrete, factual support for their arguments, which were vague and conclusory.[13] The troubled economy, therefore, was merely a basis for doubting their veracity, rather than an independent argument for enforcement.

The economy was similarly incidental to the outcome in International Business Machines Corp. v. Johnson,[14] where the court accepted the very argument that was rejected in Naden to deny preliminary injunctive relief to the employer.

In Johnson, IBM sought a preliminary injunction to prevent its former vice president of corporate development, David Johnson, from working for Dell Inc., which was alleged to be one of its major competitors.

After determining that IBM was not likely to succeed on the merits because it was unlikely to be able to establish that the noncompetition agreement had been fully executed, the court considered whether IBM would suffer dramatically greater harm than Johnson such that injunctive relief was nonetheless warranted.[15]

In concluding that it would not, the court reasoned that Johnson's ability to stay abreast of rapidly changing information about the technology industry and continued access to industry insiders and other contacts were "fundamental" to his particular skill set.[16]

As a result, the court explained, enforcement of the noncompetition agreement not only risked his new position at Dell but also threatened to force him into early retirement, "especially during these volatile economic times."[17] The economy, therefore, was merely a supportive background fact rather than an independent consideration.

In Chem-Trol Inc. v. Christensen,[18] the economy was expressly raised as a basis for denying preliminary injunctive relief but, even then, it was not given separate consideration. In that case, the court considered Chem-Trol's motion to preliminarily enjoin a long-time former employee from directly competing with it in violation of a noncompetition agreement.

Christensen had been the exclusive point of contact for Chem-Trol's customers in a large part of the Midwest for more than 20 years. After Chem-Trol terminated him, he started a directly competing enterprise and entered into contracts with numerous Chem-Trol customers.

In arguing that the balance of the hardships tipped in his favor, Christensen pointed to the state of the economy, explaining that he had been unable to find a job for more than three months.[19]

The court expressed sympathy for Christensen's situation but ultimately found that Chem-Trol stood to suffer greater harm, reasoning that it could lose "immeasurable" revenue, customer goodwill and confidential information, which could impact "the jobs of its remaining employees."[20]

The court did observe that the noncompete did not wholly prohibit Christensen from being able to turn a profit,[21] but his employability was not otherwise a factor in the court's decision.

Elsewhere, the economy has been mentioned merely in passing, as an acknowledgement of current conditions and nothing more. In Vbrick Systems Inc. v. Stephens, for example, the court concluded that the employer had not demonstrated that it would suffer irreparable harm in the absence of an injunction in part because it had admitted that its business "continues to do well despite the nation's troubled economy."[22]

In Cenveo Corp. v. Diversapack LLC, by contrast, the court found that an employer could not demonstrate irreparable harm from the loss of certain employees to the defendant because it had publicly attributed its declining productivity to the "general economic downturn" and the state of its particular industry.[23]

And in Bad Ass Coffee Co. of Hawaii Inc. v. JH Nterprises LLC, the court noted its displeasure about issuing an injunction "that likely means the loss of jobs and capital in these difficult economic times," but found that the defendants had "largely brought [it] on themselves" by knowingly taking actions contrary to a noncompetition agreement.[24]

In summary, despite massive changes in the state of the nation's financial health and the crushing blow it has dealt to the job market, noncompetition agreements continue to be analyzed under the same basic framework that developed largely during a period of economic prosperity.

Whether this result reflects the parties' failure to rely upon the recession in their arguments for and against enforceability, or judicial reluctance to modify the status quo on the basis of what inevitably is a temporary state of affairs, is unclear.

Whatever the reason, however, adherence to the manner in which discretionary considerations have been evaluated in the past does lend a welcome measure of predictability and stability in a period of economic turbulence.

--By Daniel Johnson Jr. (pictured), Larry L. Turner and Erica E. Flores, Morgan Lewis & Bockius LLP

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Morgan Lewis & Bockius LLP represents both the defendant and nonparty Dell Inc. in the Johnson case, which is pending.

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[1] See News Release, Bureau of Labor Statistics, U.S. Department of Labor, The Employment Situation — November 2009 at 1 (Dec. 4, 2009), available at www.bls.gov/bls/newsrels.htm (last visited Dec. 4, 2009).

[2] See News Release, Bureau of Labor Statistics, U.S. Department of Labor, Job Openings and Labor Turnover: September 2009 at 1 (Nov. 10, 2009), available at www.bls.gov/bls/newsrels.htm (last visited Dec. 4, 2009).

[3] Id. at 2-4 & tbls. 2, 6, 9.

[4] Id. at 4.

[5] See, e.g., Reed, Roberts Associates Inc. v. Strauman, 353 N.E.2d 590, 593 (N.Y. 1976) ("[O]ur economy is premised on the competition engendered by the uninhibited flow of services, related talent and ideas. Therefore, no restrictions should fetter an employee's right to apply to his own best advantage the skills and knowledge acquired by the overall experience of his previous employment.").

[6] See, e.g., Edwards v. Arthur Andersen LLP, 44 Cal. 4th 937 (2008) (holding that Section 16600 of California's Business and Professions Code renders all non-competition agreements void unless they fall within a statutory exception).

[7] See, e.g., Darius Int'l. Inc. v. Young, 2008 WL 1820945, at *37 (E.D. Pa. Apr. 23, 2008) (noting that, to be enforceable under Pennsylvania law, a noncompetition agreement must be "(1) related to a contract for the sale of goodwill or other subject property or to a contract for employment; (2) supported by adequate consideration; (3) reasonably necessary to protect a legitimate business interest; and (4) reasonably limited in both time and territory") (citing Piercing Pagoda Inc. v. Hoffner, 351 A.3d 207, 210-11 (Pa. 1976)); The Estee Lauder Cos. v. Batra, 430 F. Supp. 2d 158, 177 (S.D.N.Y. 2006) (noting that New York courts will refuse to enforce a noncompete unless it satisfies an "overriding limitation of reasonableness," which requires courts to "weigh the need to protect the employer's legitimate business interests against the employee's concern regarding the possible loss of livelihood, a result strongly disfavored by public policy in New York") (citing Karpinski v. Ingrasci, 268 N.E.2d 751 (N.Y. 1971)).

[8] See, e.g., Del Monte Fresh Produce NA Inc. v. Chiquita Brands Int'l Inc., 616 F. Supp. 2d 805, 816-17 (N.D. Ill. 2009) (refusing to enforce a noncompetition agreement on the grounds that it was "too broad and far-reaching" to be reasonable, noting that, in Illinois, "restrictive covenants are disfavored in the law and closely scrutinized because they are repugnant to the public policy encouraging an open and competitive marketplace") (citing Roberge v. Qualitek Int'l Inc., No. 01 C 5509, 2002 WL 109360, at *4 (N.D. Ill. Jan. 28, 2002)).

[9] See, e.g., La. Smoked Prods. Inc. v. Savoie's Sausage and Food Prods. Inc., 696 So.2d 1373, 1379 (La. 1997) (noting that a Louisiana statute forbidding enforcement of noncompetition agreements had originally been enacted in response to the Great Depression "to establish a public policy which would forbid the exclusion of individuals from the fields of work for which they were perhaps best suited at a time when the nation's economy was floundering and could not accommodate the vast numbers of workers in the workforce"); Chemart Co. v. Nixon, No. PC91-5678, 1992 WL 813516, at *8 (R.I. Super. Ct. Feb. 21, 1992) ("The enforcement of the requested preliminary injunction, especially during the current national economic recession, necessitating the termination of sales executives and the accompanying effort to gain new employment would place great restrictions on the hiring practices of competing companies and further exacerbate an already distressed economic climate.").

[10] 594 F. Supp. 2d 675 (S.D.N.Y. 2009).

[11] Id. at 680-81.

[12] Id. at 681.

[13] Id.

[14] No. 09 Civ. 4826(SCR), 2009 WL 1850316 (S.D.N.Y. June 26, 2009). In the interest of full disclosure, it should be noted that Morgan, Lewis & Bockius LLP represents both the defendant and nonparty Dell Inc. in the Johnson case, which is pending.

[15] Id. at *11 (citing Buffalo Courier-Express Inc. v. Buffalo Evening News Inc., 601 F.2d 48, 58 (2d Cir. 1979)).

[16] Id. at *14.

[17] Id.

[18] No. 09-2024-EFM, 2009 WL 331625 (D. Kan. Feb. 10, 2009).

[19] Id. at *6.

[20] Id.

[21] Id.

[22] No. 3:08-cv-1979 (CFD), 2009 WL 1491489, at *7 (D. Conn. May 27, 2009).

[23] No. 09 Civ. 7544(SAS), 2009 WL 3169484, at *6 (S.D.N.Y. Oct. 1, 2009).

[24] No. 2:09-CV-452 CW, 2009 WL 1940027, at *13 (D. Utah July 2, 2009).