

Global HR Hot Topic

June 2012

Non-Competes and Other Restrictive Covenants in a Foreign Jurisdiction



Challenge:
Employment-context restrictive covenants (non-compete, confidentiality, trade secret and non-solicitation agreements) are vital tools for international businesses in this information age. But enforcing these in foreign jurisdictions implicates wildly different rules.

Imagine, somewhere in the world, some key employee of a US-based multinational—an executive, say, or a technical expert or sales star—defects, joins a competitor and starts openly competing, divulging trade secrets and luring away former colleagues and customers. Laws on the books in many countries ostensibly protect trade secrets and require employee loyalty, but often those laws reach only *currently working* employees. (E.g., Argentine Labour Contract Law 20, 744, sec. 88; Austrian Employment Act secs. 7 and 36; Bulgarian Labor Code art. 111.) Savvy employers prefer not to have to rely on these employee loyalty or trade secrets statutes to arm them with powerful enough ammunition to stop *former* employees from sabotaging their business. Rather, to protect themselves, multinationals resort to self-help, binding key employees around the world to restrictive covenants—non-competes, confidentiality/trade secrets restrictions and non-solicitation/non-poaching/“non-dealing” agreements that prohibit poaching customers and co-workers. But a restrictive covenant that an employee knows to be unenforceable is worthless. And some jurisdictions impose fines (formerly €100,000, in Slovakia, until September 2011) merely for executing an illegal restrictive covenant.

Restrictive covenant enforceability standards vary widely from country to country, as every jurisdiction struggles to balance the competing interests inherent in enforcing these agreements. Different jurisdictions balance the competing interests in very different ways. What are the competing interests here? For an *employer*, restrictive covenants make good business sense because they help insulate a business from competition, data leaks, corporate espionage and customer/employee poaching. For an *employee*, restrictive covenants can look like handcuffs restraining the freedom to find and succeed in a new job. Another interest in the mix is *restraint on trade*—employment-context restrictive covenants can raise antitrust/competition law issues. Society, acting through law and courts in each jurisdiction, balances these interests, recognizing on one hand that yes, employers need to protect their businesses and individuals should follow commitments they contracted to

Pointer:
Craft foreign restrictive covenants to conform to local law. Understand how the relevant legal system addresses seven core issues: (1) public policy (2) consideration (3) garden leave (4) remedies (5) competition/antitrust (6) red/blue pencil clauses and (7) quirky local constraints.

Each monthly issue of *Global HR Hot Topic* focuses on a specific challenge to globalizing HR and offers state-of-the-art ideas for ensuring best practices in international HR management and compliance. White & Case’s International Labor and Employment Law practice helps multinationals globalize business operations, monitor employment law compliance across borders and resolve international labor and employment issues.

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uphold. But on the other hand, society has an interest in freeing up the newly unemployed to use their skills to earn a living and contribute to the economy while staying off the rolls of the unemployed. Society also has an interest in fostering free trade.

With each jurisdiction balancing these interests in its own particular way, a multinational operating internationally confronts a panoply of restrictive covenant enforceability standards across its worldwide operations. From a global operations perspective, accounting for so many rules gets daunting. Fortunately, determining which jurisdiction's law governs the most common type of restrictive covenant—the “plain vanilla” single-jurisdiction covenant—is easy. One-country covenants need only meet the enforceability rules of a single jurisdiction, the place where the employee works, where the covenant restricts competing/disclosing secrets/poaching, where any covenanted choice-of-law clause selects as operative law, and where some alleged violation ultimately occurs. When all those places are the same place, the employer faces no conflict-of-law analysis and enforceability is a simple question of whether the covenant conforms to the host jurisdiction's domestic law and public policy—its so-called “mandatory rules.” The more complex scenario, obviously, is a *cross-border* restrictive covenant that implicates two or more jurisdictions' laws and so triggers a conflict-of-laws problem—how to resolve competing public policies and competing “mandatory rules.” Here, to analyze restrictive covenants in a foreign jurisdiction, we address “plain vanilla” single-jurisdiction covenants in countries around the world. Then, in our July 2012 *Global HR Hot Topic*, we will take on the conflict-of-law issue inherent in *cross-border* restrictive covenants.

Courts in every country tend to be reluctant to force former employees to heed non-compete, confidentiality/trade secret and non-solicitation restrictions buried in a prior employer's low-touch human resources policy, company rule, code of conduct or employee handbook. A restrictive covenant, to be restrictive, needs to be a covenant. For a restriction to be enforceable after an employee leaves the workplace, the ex-employee should have, at some point, contractually bound himself to it. But even where a former employee signed a restrictive covenant, local courts will not necessarily enforce it. Enforceability in each jurisdiction turns on a number of local legal and public policy standards. A multinational that imposes restrictive covenants on its staff needs a strategy to enhance enforceability in each relevant jurisdiction.

In a number of jurisdictions including Chile, India, Russia, Mexico, Vietnam and the US states California and North Dakota, post-employment non-competes—but not necessarily other restrictive covenants nor necessarily sale-of-a-business-context non-competes—are, for the most part, void. And in a handful of jurisdictions, other types of restrictive covenants are not

necessarily enforceable; for example, post-employment non-solicitation agreements that prohibit poaching customers and co-workers are void in Russia and disfavored in Hong Kong. Always begin restrictive covenant analysis by checking that the proposed covenant is viable in the relevant jurisdiction.

Good starting points for researching restrictive covenants abroad include: *W. Lazar & G. Siniscalco, Restrictive Covenants and Trade Secrets in Employment Law* (2 vols., ABA/BNA 2010 & supp.); *P. Lagesse & M. Norrbom, Restrictive Covenants in Employment Contracts and other Mechanisms for Protection of Corporate Confidential Information* (Kluwer Law 2006); *Ius Laboris, Non-Compete Clauses: An International Guide* (Ius Laboris printing 2010).

The most fundamental strategy for drafting a “plain vanilla” single-jurisdiction covenant is to start with a *locally tailored* form. The best single-jurisdiction restrictive covenants are always organic local ones and the worst are always those thoughtlessly transplanted from abroad. In the single-jurisdiction context where the employee gets hired, works and, after separating, remains in a single jurisdiction (and where any covenanted choice-of-law clause invokes that same jurisdiction's law), restrictive covenant enforceability analysis is a straightforward matter of “coloring within the lines”—adhering to the strictures of what the host jurisdiction requires. Because enforceability rules differ markedly across jurisdictions, restrictive covenant boilerplate perfectly appropriate for one place will not necessarily be enforceable even in a neighboring jurisdiction. A non-compete form that works in Arizona may contain provisions void in California and Mexico; a viable English form may omit clauses necessary in France and Belgium.

After selecting the right restrictive covenant form, tailor a covenant for your specific situation. Even within a given country, one form, unchanged, will not work in all situations. What was appropriate for the last employee may need tweaking for this one. What works for an executive will not likely work for a secretary. When tailoring a new restrictive covenant—or, for that matter, when seeking to enforce an existing covenant against some ex-employee who might now be flouting it—analyze the relevant legal system's take on seven core issues: (1) public policy (2) consideration (3) garden leave (4) remedies (5) competition/antitrust (6) red/blue pencil clauses and (7) quirky local constraints.

1. **Public policy.** To be enforceable, a restrictive covenant must conform to the relevant jurisdiction's public policy—the society's unique balance of competing interests inherent in enforcing a restrictive covenant. Even if both parties freely agree to restrictions that violate so-called local “mandatory rules,” local courts will void the parties' arrangement as unenforceable because it offends local public policy. For example, Austria, the Czech Republic and (in most cases) England treat non-competes running more than one year after employment

as *per se* unreasonable. Local courts in those jurisdictions, therefore, will refuse to enforce any three-year non-compete, no matter how artfully articulated or how freely and unambiguously consented to. Courts' rationale here parallels the reason courts reject contracts executed by children, contracts for the sale of heroin and contracts for prostitution: Contractual arrangements that violate statutes or offend public policy are void no matter how clearly and willingly parties themselves agree to comply.

In every jurisdiction that enforces these restrictions, it is easy to craft a compliant and enforceable covenant. But employers want more than more enforceability. An obviously enforceable covenant is usually too anemic—a 20-day non-compete limited to a four-block radius may be unquestionably enforceable as to time and territory, but its restriction is worthless to employers. Employers prefer restrictive covenants that push the margins of what local jurisdictions accept.

In assessing whether a given covenant meets a jurisdiction's public policy, look to what that jurisdiction deems "reasonable." Courts usually require post-term restrictions be "commercially reasonable"—in the words of the French Labor Code (article L. 1121-1), a restriction must be "justified by the nature of the job...and proportionate to the goal sought." We have seen that "reasonableness" is a local analysis; a scenario that one jurisdiction accepts as reasonable can, in another, be unacceptable. Within a single jurisdiction, "reasonableness" analysis differs from case to case. A long global non-compete reasonable for a senior executive will be held unreasonable for his secretary. In assessing what is commercially reasonable, courts the world over tend to scrutinize the same pool of four core "reasonableness" topics: *duration, geographic footprint, industry and reason for leaving.*

- **Duration.** Where restrictive covenants are allowed at all, public policy voids as unreasonable employment-context covenants that run too long after employment. How long is too long? In the post-employment context, 20 years is always too long and 20 days is never too long. Where to draw the line between those extremes depends on two issues: local law and specific employee situation. As to local law, most US states accept at least some employment-context non-competes of two or more years—but English decisions get reluctant to enforce employment-context non-competes beyond six months, with only a handful of cases accepting beyond one year. Venezuela imposes a statutory cap of six months after employment; Austria, the Czech Republic and Slovakia impose statutory caps of one year, and China, Germany, Portugal, Saudi Arabia, Spain, and Sweden impose caps of two years. As caps, these are outside parameters, and so the focus becomes the specific employee situation. Again, a long non-compete reasonable for a senior executive will be unreasonable for his secretary.

- **Geographic footprint.** Where restrictive covenants are allowed at all, law most everywhere voids, as unreasonable, covenants, particularly non-competes, that stretch across too big a territory. How big is too big? This analysis also depends on the two issues of local law and specific employee situation. As to local law, tiny jurisdictions like Singapore and (to a lesser extent) Hong Kong frown on non-competes confined even to a city, whereas big jurisdictions like many US states sometimes accommodate even global restrictions. But jurisdiction size is not always determinative: Argentina, for example, questions the enforceability of non-competes with a footprint bigger than the country (but case law there continues to evolve). As to specific employee situations, within any one jurisdiction the reasonableness of a given covenant's footprint turns on the facts. A senior executive with global responsibilities always supports a bigger restricted territory than a hairdresser drawing customers from a single neighborhood.

- **Industry.** Where restrictive covenants are allowed at all, law in perhaps every jurisdiction will void covenants—particularly customer poaching prohibitions and non-competes—unless they delimit a reasonably restricted industry, sometimes referred to as the covenant's "scope," "subject matter" or "field of activity." Trying to stop an ex-employee from taking any job for any employer or from launching a business in any industry whatsoever is impossible to justify as commercially reasonable even in the sale-of-a-business context. What legitimate business interest does a tech company or auto-parts maker have in stopping former engineers from working as fitness trainers or from joining the priesthood? What legitimate business interest does a bank or accounting firm have in stopping former financial managers from soliciting customers to buy Amway products or to donate to animal shelters? To enhance reasonableness and enforceability, always limit non-compete and customer poaching restrictions to the narrowest possible industry scope. For example, a scope defined as "consultants" or even "compensation consultants" may be too broad; better would be "board of director compensation consultants." A scope defined as "fund managers" or even "hedge fund managers" may be too broad; better would be "distressed-asset hedge fund managers." Or else tailor the restriction to a list of named competitors.

- **Reason for leaving.** Courts rarely include "reason for leaving" among the elements they say they account for when assessing the commercial reasonableness of a post-term restrictive covenant, but in practice this can be the most vital factor in determining outcomes of non-compete and customer poaching litigation. Courts are far more comfortable enforcing post-term restrictive covenants against quitters than against hapless victims of no-cause

firings. If an employer that fired someone without cause is so convinced that employee poses such a competitive threat, a judge will wonder, why did the employer fire him? In jurisdictions like Austria, Turkey and the Netherlands, non-competes are flatly unenforceable against employees fired without cause or at least against those fired *wrongfully*. In the US, having been fired “will, at least to some degree, compromise enforceability” of a restrictive covenant in “New York,” “Pennsylvania,” and beyond. (D. Woolf & M. Furlane, “The Fired Employee’s Non-Compete Agreement,” *newsletter republished* by Lexology, Dec. 22, 2011.) The same could be said for China and many other countries.

2. **Consideration.** Many jurisdictions refuse to enforce an otherwise commercially reasonable restrictive covenant unless it is supported by adequate “consideration”—something of value one party gives up in exchange for the other party’s commitment to do or refrain from doing something. In the international restrictive covenant context, consideration requirements break down into two very different, but frequently confused, categories: *contractual consideration* versus what we might call “*staying-out-of-the-game*” compensation.

- **Contractual consideration.** Common law jurisdictions require that any binding contract or covenant, even if signed by both parties, be supported by three elements: offer, acceptance—and consideration. Under common law-contract analysis, one party’s offer and another party’s acceptance, without consideration, merely add up to an unenforceable promise—if *I offer to mow your lawn tomorrow and you agree to let me mow it, even if we agree in writing, you cannot enforce my promise because it is gratuitous, you gave up no consideration in exchange*. Sometimes employment itself, be it a paid job for a new hire or continued work for a current employee, can count as enough consideration to support a covenant, but some jurisdictions require consideration other than the job, on the theory that the job already acts as consideration for wages received. Earmarked restrictive covenant consideration is particularly likely to be necessary where current staff (as opposed to new hires) sign restrictive covenants after already having started work. Where parties designate a pay raise or bonus as restrictive covenant consideration, employers might accommodate the requirement for earmarked restrictive covenant consideration simply by relabeling compensation: For example, for every \$1,000 the employer was prepared to pay in extra wages, the parties might label \$800 as “salary” or “bonus” and designate the other \$200 as “restrictive covenant consideration.”

- **“Staying-out-of-the-game” compensation.** Common law jurisdictions tend to require contractual consideration to make a promise binding as a contract. Civil law countries, by contrast, tend not to require contractual consideration where both parties freely and unambiguously execute a covenant. Instead, though, a number of civil law jurisdictions require much more expensive “staying-out-of-the-game”

compensation, mandated to help employees make ends meet during a post-term restrictive covenant period. Civil law systems from Argentina and Brazil to China, Czech Republic, France, Germany, Hungary, Italy, Poland, Sweden, Taiwan, Venezuela and others explicitly or implicitly require paying compensation to ex-employees for their post-term non-competes to be binding in court. The idea is to compensate the employee for “staying out of the game,” refraining from competing and perhaps remaining underemployed during the non-compete term. If the legal system is to enforce a business’s contractual power to keep some ex-employee idle and out of the workforce, the jurisdiction requires the business to step up and support its former employee off the public dole. The idea is perhaps similar to requiring child support in a divorce: Just as an absentee parent who no longer provides a home for a dependent child needs to pay support, so do employers that no longer provide a job but seek to enforce covenants that keep ex-employees underemployed and dependent.

Staying-out-of-the-game compensation sometimes makes sense to offer even in jurisdictions where it is not mandatory. In doing a “commercial reasonableness” analysis, jurisdictions like Australia that do not flatly require this compensation nevertheless view it as supporting the reasonableness of a post-term restriction.

Jurisdictions like Italy let employers pay staying-out-of-the-game compensation *during* employment, paying in advance for the non-compete to become binding later, upon separation. (Presumably the employee banks the earmarked extra compensation for a nest egg to spend during the post-term non-compete period.) Employers might meet this requirement without spending extra money if they pay the mandated restrictive covenant compensation with regular payroll, earmarked and labeled as restrictive covenant compensation but in an amount by which they reduce the employee’s base pay or bonus.

Examples of jurisdictions that require non-compete “staying-out-of-the-game” compensation include:

- **Argentina and Brazil.** Right-to-work provisions in the Argentine and Brazilian constitutions cast a long shadow over the enforceability of post-term restrictive covenants. Restrictive covenant law in both countries is underdeveloped, but neither seems to interpret its constitutional right-to-work provision as strictly as Mexico and Chile do, banning non-competes entirely. Rather, the prevailing view in Argentina and Brazil is that post-term non-competes are unconstitutional unless the employer pays enough to assuage the constitutional concern. Compensation amounts, though not fixed, may need to run about 50 to 60 percent of final average pay. These payments might possibly be structured as earmarked money paid during employment, and so perhaps the compensation may not have to be tendered over the post-term non-compete period.

- **China.** China's Labor Contract Law (article 23) requires employers pay post-term non-compete compensation monthly during the post-term period. But that law offers no guidance as to how much to pay. Since 2009, municipalities from Beijing to Shanghai to Shenzhen have issued local guidelines setting out minimum post-term non-compete compensation in amounts clustering from 20 to 60 percent of final average monthly pay.
 - **Czech Republic, Germany, Hungary, Poland, Slovakia, Sweden and Venezuela.** Statute or code provisions require employers pay some compensation to support post-term non-competes in jurisdictions from the Czech Republic, Germany, Hungary and Poland to Sweden and Venezuela. Minimum compensation amounts vary, with 25 percent of monthly final average full pay (including bonus and benefits) due in Poland and 50 percent due in Germany, Hungary and Slovakia. In Sweden, the employer must fund the difference between final average pay and likely earnings during the non-compete period, capped at 60 percent of final average pay.
 - **France and Italy.** Three French Supreme Court cases of 2002 require post-term compensation to support a post-term non-compete. France does not impose any statutory minimum, although 30 percent of final average total pay and benefits, tendered monthly during the non-compete period, is considered the floor. Sectoral collective bargaining agreements often set non-compete pay. Italy does not impose any minimum post-term compensation, either, other than requiring pay be "congruous" with the covenant, which in practice means at least 10 to 35 percent of final average gross pay. Again, the employer can tender it in advance of separation.
 - **Taiwan.** Post-termination compensation is not only necessary to support a post-term non-compete in Taiwan, but paying full salary—100 percent of final average pay—is recommended to guarantee a non-compete's enforceability, essentially becoming "garden leave."
3. **Garden leave.** The term of a typical restrictive covenant runs both during and after employment, but employers rarely ever sue their current staff. As mentioned, in countries like Argentina, Austria and Bulgaria, the local labor codes draw an express distinction between employment-term versus post-term restrictions, imposing only restrictions during employment. So the "acid test" for any employment-context restrictive covenant is its enforceability *after an employee leaves*. One increasingly common way to sidestep post-employment restrictive covenant enforceability barriers is to convert post-termination restrictions into *employment-period* restrictions using so-called "garden leave"—keeping the employee employed and payrolled but excused from job duties for the entire non-compete period, after what otherwise would have been the separation date (thereby leaving the employee free to putter around his garden but forbidden to compete, solicit or breach confidentiality). Garden leave simplifies restrictive covenant enforcement, but at an incredibly high price: full base pay. And so garden leave, popular abroad, gets lauded as an easy way around restrictions on post-term restrictive covenants. But the cost of garden leave makes it too rich for many employers' blood. Another drawback to garden leave, particularly in the eyes of US employers, is that keeping a non-producer on the payroll and technically employed risks fresh liabilities: What if a disgruntled and idle garden-leaver claims to suffer some "workplace" injury during leave? What if he accuses the employer of harassment or psychological abuse committed during leave? What if he commits sabotage or sows dissent among co-workers? Do local law or company policies require keeping garden-leavers fully enrolled in bonus, equity and other benefit plans—and on the email system and invited to company social events?
4. **Remedies.** When an employee subject to a restrictive covenant quits and defects to a competitor, the original employer often seeks a quick and tough remedy like a restraining order, injunction, court order or other equitable relief. But the distinction between law and equity is unique to the common law. Americans expect judges to enjoin breaches of post-term covenants, but civil law jurisdictions like Spain can be extremely reluctant to grant and police enforceable injunctions against former staff, and many countries' courts lack police power to enforce civil injunctions on behalf of non-government parties. One Argentine law firm newsletter explains that injunctions in the non-compete context are theoretically available in Argentina—but then adds: "However, although [an injunction] could be requested, the chances of [an Argentine] court ordering an employee not to work for a competitor...are low."
- Where an enforceable injunction is unlikely, consider building alternate remedies into the covenant itself. The obvious alternate remedy is a liquidated damages clause in which the employee concedes that breach will injure the employer in ways so hard to quantify that the employee hereby commits to pay a fixed ("liquidated") amount—\$X—as damages if he later exercises his freedom to act inconsistent with the covenanted commitment. Set "\$X" at an amount that would be a strong disincentive for this particular employee but low enough that a court might reasonably expect him to pay. Liquidated damages clauses should release employers from the burden later to prove actual out-of-pocket damages—the employer only need establish a breach occurred that triggered the employee's obligation to pay the liquidated amount. But check local enforceability. In Saudi Arabia, restrictive covenant liquidated damages clauses are said to be void, and countries from Austria and China to New Zealand scrutinize liquidated damages clauses subject to a judge's confirmation as reasonable. Slovakia caps liquidated damages

at the employee's total post-term compensation. One common and widely enforceable liquidated damages provision (or penalty) is forfeiture of unexercised stock options.

Building a liquidated damages remedy into a restrictive covenant also serves an entirely different purpose: It might resuscitate or at least support an arguably void restriction. In jurisdictions where a restrictive covenant may otherwise be held void, a carefully worded liquidated damages clause might at least crack open the door to an argument that the parties' covenanted restriction escapes the local ban. For example, Mexico's constitution (at articles 5, 28, 123(aa)) and Chile's constitution (at article 19, sections 16, 21) are said to prohibit non-competes. But under Mexican and Chilean law, an employee's promise to pay a reasonable liquidated fee if he exercises his constitutional freedom to compete might possibly escape the constitutional ban, on the theory that the payment obligation is not really a restriction at all, just a sort of royalty due only if the employee himself decides to trigger it. In Mexico and Chile, an even better liquidated damages strategy is to pay the employee some earmarked "non-compete compensation" money up front, *during* employment, perhaps relabeled bonus money. Then structure a clause into an agreement that lets the employer claw this payment back if, after employment, the employee chooses to violate non-compete terms.

5. **Competition/antitrust.** Many jurisdictions, including the European Economic Area, see non-competes and other restrictive covenants as potential *restraints on trade*. Local competition/antitrust laws usually accommodate certain restrictive covenants with some local exception or exclusion, but a given restrictive covenant needs to fit. Always adapt a covenant to comply with competition/antitrust rules.
6. **Red/blue pencil clauses.** Because a restrictive covenant can be so fragile, multinationals often bake into their covenants a so-called "red" or "blue pencil" clause that empowers a judge, if any provisions are held to violate applicable rules, to reform the covenant, keeping it as restrictive as possible within the confines of local standards. Whether or how these clauses work differs depending on the jurisdiction. Australia usually requires that these clauses spell out each less-restrictive alternative.
7. **Quirky local constraints.** Some jurisdictions impose quirky constraints on restrictive covenants. Check local law for issues like these:
 - **Earnings threshold.** Under the Austrian Employment Act (section 36) and under similar provisions in Belgium and elsewhere, post-term non-competes are void unless the employee's final average pay exceeds a statutory threshold—€2,380 per month in 2011, in Austria.

- **Position of trust.** Jurisdictions including China, Denmark and Turkey void post-term non-competes unless the employee had access to trade secrets or customers, or at least held a high-level executive position or so-called position of "trust." In Hong Kong (at least under one line of cases), *non-solicitation* provisions may be enforceable only against senior executives—even though Hong Kong courts regularly uphold non-competes against hairdressers and dog groomers.
- **Probation.** In the Czech Republic, a post-term non-compete is void if the employee signed it while working a probation period.
- **Job change.** If an employee in the Netherlands signs a non-compete while working one position but then later transfers (through promotion or reassignment) into a different job, the non-compete restriction is likely void unless the employee expressly reaffirms it after the switch.
- **Professionals.** In France and elsewhere, licensed practicing professionals such as doctors and lawyers are not considered regular employees and therefore cannot usually be bound to restrictive covenants.
- **Waiver restrictions.** Some of the jurisdictions that require paying expensive post-term "staying-out-of-the-game" compensation regulate when and how an employer can waive a post-term non-compete. In these jurisdictions, employers obviously prefer the freedom to waive a non-compete—thereby saving the compensation money—if an employee leaves under circumstances that pose no competitive threat (such as by retiring, disability, changing careers, moving out of the non-compete territory, joining the navy, becoming a priest). In jurisdictions like the Czech Republic and France, though, employers that delay find themselves unable to waive and forced to pay.

In our next Global HR Hot Topic, July 2012, we address non-competes and other restrictive covenants in the cross-border context—where the geographic scope goes beyond one jurisdiction, or the employee is mobile, or a choice-of-law clause selects another jurisdiction's law.