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OPINION

Thorny questions, issues emerging as noncompete act takes hold

By David S. Rubin

For the past two months, my colleagues and I have been rewriting clients' noncompete agreements to conform to the new Massachusetts Noncompetition Agreement Act, which was enacted over the summer and went into effect on Oct. 1.

As has been widely discussed, there are a number of open issues and questions under the act that are expected to be resolved eventually through litigation. Not surprisingly, clients don't seem comforted by that prospect as they revise their agreements.

In any event, what follows is a collection of some of our favorite open issues, questions and observations.

Mutually agreed-upon consideration

This seems to be everyone's favorite open issue. The act states that a noncompete agreement must be "supported by a garden leave clause or other mutually agreed-upon consideration."

The act makes clear that a garden leave must be paid at 50 percent of base salary, but does not discuss what "other mutually agreed-upon consideration" might be sufficient.

Prior to the act, it was generally accepted that an offer of employment could be valid consideration for a noncompete agreement. Given the various restrictions and requirements set forth in the act, it seems counterintuitive to believe that a job offer could still be valid consideration.

Yet, there is some basis in the act supporting the argument that an offer of employment is sufficient consideration. Section b(i) of the act addresses noncompete agreements entered into at the time of hire, and it says nothing about what might constitute sufficient consideration.

Section b(ii), on the other hand, addresses agreements entered into with current employees, and it expressly states that such agreements must be supported by consideration "independent from the continuation of employment."

One might argue — and presumably some litigant eventually will argue — that the absence of such an explicit requirement of independent consideration for new hires implies that a job offer can be valid consideration, especially where the act contains such an express requirement for current employees.

If it turns out that an offer of employment is not sufficient, we're still wondering what measure of "mutually agreed-upon consideration" short of garden leave at 50 percent pay will suffice. Could it be a $1,000 signing bonus? How about a grant of stock options that might never actually have any value?

Employment relationship

The act defines a noncompete agreement covered by the act as "between an employer and employee, or otherwise arising out of an existing or anticipated employment relationship."

A couple of our corporate law partners have asked whether this would apply to noncompete provisions in shareholder agreements, where the shareholders are required to be employees of the company.

In some privately held companies, a valued employee may be offered an ownership interest in the form of shares. The employee generally will be required to sign on to a shareholder agreement to which the company and all the other shareholders are parties, and which may contain a noncompete provision.

Is such an agreement between an employer and employee, or is it between the company and shareholder? Does it arise out of an employment relationship, or out of a shareholder relationship?

The same questions can be asked in the context of partnership agreements or LLC operating agreements, under which a key employee may be invited to join the partnership or become an LLC member. Some future litigant will likely note that, unlike shareholders, partners and LLC members are not considered "employees" — or at least not for tax purposes.

Non-exempt employees

The act states that noncompetes are not enforceable against employees who are "classified as nonexempt under the Fair Labor Standards Act." That seems pretty straightforward, except that it's not always clear whether an employee should be classified as exempt or non-exempt.

And, of course, companies have been known to misclassify employees as exempt, and therefore not entitled to overtime pay.

Employers, therefore, should expect that former employees may attempt to defend against the enforcement of noncompete agreements by claiming that they were, in fact, non-exempt under the FLSA.

More ominously, employers should anticipate counterclaims in which employees claim that they were misclassified as exempt and are owed three years of unpaid overtime wages — trebled under Massachusetts law.

Cause

Under the act, a noncompete that otherwise conforms to the law cannot be enforced against an employee who has been "terminated without cause." There has been a fair amount of speculation as to what might constitute "cause," as the term in not defined in the act.

Executive employment agreements and similar documents often include definitions of cause, such as insubordination, material violation of company policies, fraud or embezzlement, or conviction of a felony.

It seems reasonable to write such standards into a noncompete agreement, but it will be interesting to see how far employers might press this issue, or how much latitude the courts will permit.

For example, could a failure to meet a prescribed sales quota or other performance standard be deemed "cause" for purposes of the act?

Forfeiture for competition agreement

The definition of noncompete agreements covered by the act includes "forfeiture for competition agreements." In a forfeiture for competition agreement, a former employee will lose some type of financial benefit if the employee violates a post-employment noncompetition restriction. This will have particular significance for various types of stock option, deferred compensation and retirement plans.

For example, in a Supplemental Employee Retirement Plan agreement, an employer typically promises that, if an employee continues to work for the employer for a certain number of years and until a specified age, the employer will continue paying a percentage of the employee's salary for some number of years after he or she retires.

SERPs often include noncompetition clauses stating that the SERP benefits will cease if the employee goes to work for a competitor after retirement. Thus, such SERPs presumably will be covered by the act as forfeiture for competition agreements.

Of course, the forfeiture provisions of the SERP may still be enforceable if the SERP benefits meet the standards for "garden leave" under the act. And even if they don't, perhaps the SERP benefits will be sufficient as "other mutually agreed-upon consideration."

Separation agreements

The act excludes from coverage separation agreements that contain noncompetition provisions, provided the employee is given a seven-day period to rescind acceptance of the separation agreement.

Oddly, that could result in employees who are terminated without cause receiving lesser benefits for noncompetition restrictions than employees fired for cause.

For example, let's assume employees Bob and Carol are hired the same day and sign identical noncompetes that fully conform to the act. The agreement provides that if the employee (Bob or Carol) resigns or is terminated for cause, the company will pay the employee 50 percent of his or her salary for one year during which the employee cannot work for a competitor.

After some period of time, Bob sexually harasses a co-worker and is fired for cause. In order to enforce the agreement, the company must pay Bob half of his salary for a year.

At the same time, let's suppose, the company reorganizes Carol's department and her employment is terminated as a result. As the termination was without cause, the company cannot enforce her noncompete but is under no obligation to continue paying any part of her salary.

However, in exchange for a release of claims and a one-year noncompete, the company offers her three months' severance pay — half of what Bob is receiving. As Carol's noncompete is part of her separation agreement, it is not covered by the act.

There are other thorny questions and issues that have emerged and still others likely to come. For the most part, I suspect, our clients are hoping that someone else will litigate them.

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