Employment

Employers Can Prevent Doomsday Scenario With Restrictive Covenants

by Nick Birkenhauer

A company's most valuable asset is its customers. Businesses expend a great deal of energy to develop and maintain client relationships. What happens, though, when an employee exits the company to start a competing business and takes valuable clients with him? Without adequate safeguards, the results can be devastating.

The best way a business can protect itself from this scenario is through the use of employee non-competition, non-solicitation and non-disclosure agreements (often referred to collectively as "restrictive covenants"). Broadly speaking, a non-competition agreement is a contract which prohibits an ex-employee from competing against his former employer for a specific period of time and within a specific geographic territory. A non-solicitation agreement prohibits an ex-employee from soliciting business from, or doing business with, his former employer's customers and vendors. A non-disclosure agreement prohibits an ex-employee from disclosing any of his former employer's intellectual property or other confidential information – such as customer lists and pricing information – to any third party.

When used together, restrictive covenants can effectively prevent a doomsday-type scenario where a key employee abruptly leaves a company and begins doing business with his former company's clients. Sales is a field that is particularly vulnerable to such a scenario. A salesperson who knows his former company's pricing information and who has established relationships with the company's best customers, could lure away those customers with promises of lower prices. Restrictive covenants can help prevent this scenario.

Purchasing a business is another situation in which restrictive covenants are worth their weight in gold. The purchaser of a business certainly does not expect to compete with the seller of the business once the sale is finalized, but without the inclusion of restrictive covenants in the purchase agreement, that is exactly what may happen. In this context, restrictive covenants operate to prevent the seller from remaining in the same business or doing business with its old customers once the sale is final.

To be enforceable, restrictive covenants must comply with very specific legal requirements. Courts carefully scrutinize the contents of the written contract to ensure that the terms of the restrictive covenants are reasonable and that all requirements for a valid contract have been met. Proper drafting, therefore, is critical.

In virtually every state, including Kentucky and Ohio, courts require restrictive covenants to be reasonable in the scope of both time and geography. What is "reasonable" varies greatly from case to case and is an extremely fact-sensitive question. Generally speaking, restrictive covenants are reasonable only to the extent that they are necessary to protect the employer's legitimate business interests.

Using the sales example from above, if a company sells products throughout the entire states of Kentucky and Ohio, then a court would likely hold that it is reasonable to restrict an employee from competing within either of those states. By contrast, if the company's sales area included only the Greater Cincinnati region, then that would be the maximum permissible geographic scope of the restrictive covenants.

Restrictive covenants generally apply for the duration of employment and then for a specific number of years following separation of employment. The time covered must be reasonable. Depending on the circumstances, a period of one, three or five years following separation of employment may be appropriate.