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LABOR AND EMPLOYMENT LAW: THE BASICS*

*TRADE SECRETS, COVENANTS NOT TO COMPETE
AND NON-SOLICITATION AGREEMENTS: BASICS*

**DRAFTING CONFIDENTIALITY, NON-COMPETE &
NON-SOLICITATION AGREEMENTS:
THE EMPLOYEE'S WISH LIST**

By:

Mary L. Mikva
Abrahamson Vorachek & Mikva
120 N. LaSalle Street, Suite 1050
Chicago, IL 60602
(312) 263-2698
mmikva@avmlaw.com

MARY L. MIKVA
Abrahamson Vorachek & Mikva
120 North LaSalle Street
Suite 1050
Chicago, IL 60602
Phone: (312) 263-2698
Fax: (312) 419-6770
mmikva@avmlaw.com

Mary Mikva is a 1980 graduate of the Northwestern University Law School in Chicago, Illinois. She graduated cum laude and Order of the Coif. Following law school, Ms. Mikva was a judicial law clerk, first for Judge Prentice H. Marshall, of the Northern District of Illinois, and then for Associate Justice William J. Brennan, Jr., of the United States Supreme Court.

Ms. Mikva is currently a partner in the law firm of Abrahamson Vorachek & Mikva, which specializes in representing plaintiffs in employment cases. Ms. Mikva has handled numerous employment cases, including ERISA, wage and hour, sex, age, race and disability discrimination, and harassment matters. She practices in federal and state court as well as at the Chicago Commission on Human Relations and the Illinois Human Rights Commission. She has been appointed as class counsel in several large class actions involving discrimination or other employment claims.

Ms. Mikva is an adjunct trial practice professor at Northwestern University Law School and also teaches Deposition Practice and Negotiation and Mediation for the National Institute of Trial Advocacy. She is an active member and frequent speaker for the Chicago Bar Association, the American Bar Association, and the National Employment Lawyers Association. She is also a fellow of the College of Labor and Employment Lawyers.

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I. INTRODUCTION: WHAT LEVERAGE DO WE HAVE?

Generally, when an employee's attorney becomes involved in drafting confidentiality, non-compete or non-solicitation agreements, it is in the context of an overall employment contract. Hopefully, that contract has some significant benefit to the employee, such as an agreed-upon severance payment, a golden parachute in the case of a change of control or an agreed-upon bonus. Generally, these benefits are more important to the employee at the time of the negotiations than the confidentiality, non-compete or non-solicitation components of the agreement. However, later, when and if the relationship sours and the employee finds himself out of a job, these restrictive covenants can make it impossible for that employee to find alternative work. Thus, the time to negotiate on these issues is at their inception -- when the employee still has some leverage and when the employer has some reason to accommodate the employee's needs.

The employee and the employee's lawyer should be aware going into the negotiation that your leverage is only as strong as the employer's desire to keep the employee happy. The employer is entitled to take a take it or leave it attitude. Firing an employee for refusing to sign a non-competition agreement is not illegal. The Seventh Circuit, in O'Regan v. Arbitration Forums, Inc., 121 F.3d 1060, 1064 (7th Cir. 1997) summarized the law as follows:

O'Regan also argues that firing her for refusing to sign the non-competition agreement was itself a retaliatory discharge. Because she believes that A.F.'s non-competition agreement itself violates federal and state antitrust laws, she believes that to fire her for refusing to sign it constitutes a retaliatory discharge in violation of Illinois public policy. O'Regan's claim again fails. She cannot show that firing her for refusing to sign the non-competition agreement violated Illinois public policy. While a cause of action for retaliatory discharge is allowed where the public policy is clear ... the cause of

action is denied where it is equally clear that only private interests are at stake. (citations omitted).

Employee's counsel may gain some leverage in these negotiations by suggesting to the employer's counsel that a negotiated clause is far more likely to be upheld by a court as reasonable, if it is challenged down the road. Moreover, as explained in David Carr's excellent paper, from the management perspective, a good management lawyer will recognize that in overreaching, an employer may end up with a restrictive covenant that is unenforceable.

II. CONFIDENTIALITY, NON-SOLICITATION AND NON-COMPETITION: WHAT'S THE DIFFERENCE?

Although confidentiality agreements, non-solicitation agreements and non-compete agreements often appear in the same employment agreements and sometimes even in the same paragraphs, they are, in fact, different kinds of agreements and raise different kinds of concerns.

A. Confidentiality Agreements

A confidentiality agreement protects trade secrets and other confidential information. Much of what is protected in a confidentiality agreement is already protected under common law or by statute. Illinois has adopted, with some minor modifications, the Uniform Trade Secrets Act (UTSA). It is codified as the Illinois Trade Secrets Act (ITSA), 765 ILCS 1065/1 *et. seq.*

The ITSA protects "trade secrets" which is defined as follows:

Information, including, but not limited to, a formula, pattern, compilation, program, device, method, technique, drawing, process, financial data, or list of actual or potential customers or suppliers, that: (1) is sufficient secret to derive independent economic value, actual or potential, from not being generally known to other persons who can obtain economic value from its disclosure or use; and (2) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy or confidentiality.

765 ILCS 1065/2(d).

Through an enforceable confidentiality agreement, an employer may seek to protect material that is not properly characterized as a trade secret and thus may broaden the protection inherent in state law. See, e.g., Smith Oil Corp. v. Viking Chemical Co., 127 Ill.App.3d 423, 427 (2nd Dist. 1984).

However, an even more significant purpose of a confidentiality agreement from an employer's perspective is that it can help employers protect trade secrets under the statute because the agreement reflects the employer's security measures to maintain the secrecy or confidentiality of its information. As the statutory definition makes clear, a trade secret will not be protected unless it is the subject of effort to maintain its confidentiality.

Generally speaking, a confidentiality agreement is far more likely to be upheld by the courts and far less onerous to the departing employee, than either a non-solicit or a non-compete agreement. The Illinois Appellate Court summarized the difference in the treatment the courts give these kinds of agreements as follows:

A post-employment restrictive covenant will be enforced if its terms are reasonable. *** The reasonableness of some types of restrictive covenants, such as non-solicitation agreements, also is evaluated by the time limitation and geographical scope stated in the covenants.

However, a confidentiality agreement will not be deemed unenforceable for lack of duration or geographic limitations where trade secrets and confidential information are involved. *** Unlike the traditional line of restrictive covenant cases, the confidentiality agreement at issue in the instant case does not impose any of the typical restrictions commonly adjudicated in restrictive covenant cases. Defendant does not seek to restrain plaintiff's future career.

Coady v. Harpo, 719 N.E.2d 244 (1st Dist. 1999)(upholding a confidentiality covenant executed by a senior associate producer of The Oprah Winfrey Show, although it contained no temporal or geographic limits.)

Generally, a confidentiality agreement is something on which an employee should acquiesce. However, a potential hidden danger for the employee in a confidentiality agreement, is the inevitable disclosure doctrine. This doctrine allows an employer to try to curtail the post-employment activities of one of its former employees, even in the absence of an agreement not to compete or not to solicit customers. Under this doctrine, an employer may obtain an injunction against a former employee working for a competitor based on the theory that the employee will inevitably use or disclose the trade secrets or confidential information of the former employer in carrying out his or her new duties. The assumption of the court, in applying this doctrine, is that the trade secrets at issue are so ingrained in the employee's mind that the employee cannot avoid relying on them.

Unfortunately, one of the leading proponents of this doctrine is the Seventh Circuit. In Pepsico, Inc. v. Redmond, 54 F.3d 1262 (7th Cir. 1995), the general manager for Pepsi-Cola's California's operation joined Quaker Oats to work in its Gatorade/Snapple Division. Pepsico alleged that the employee (Redmond) knew the contents of and would inevitably disclose Pepsi's

strategic plan. The district court held that there was a clear threat of misappropriation and enjoined Mr. Redmond from starting the new job for six months. The Seventh Circuit affirmed, finding the risk of inevitable disclosure very high:

Pepsico believed that Quaker, unfairly armed with knowledge of [its business] plans, will be able to anticipate its distribution, packaging, placing and marketing moves. Redmond and Quaker even conceived that Redmond might be faced with a decision that could be influenced by certain confidential information that he obtained while at Pepsico. In other words, Pepsico finds itself in the position of a coach, one of whose players has left, play book in hand, to join the opposing team before the big game.

54 F.3d at 1270.

B. Non-Solicitation Agreements

There are two kinds of non-solicitation agreements, one not to solicit employees, the other not to solicit clients. The latter operates as a non-compete agreement and can and often does interfere with a departing employee's ability to get another job.

The following is an example of a covenant not to solicit employees:

Employee further agrees that during his or her employment with the company and for a period of one year following the termination of that employment, whether such termination is voluntary or involuntary and regardless of the reason for such termination, he or she will not, on behalf of himself or on behalf of any other person, firm, or corporation, solicit an employee of the company to leave the employ of the company or to become employed by any person, firm or corporation engaged in competition with the company.

The following is an example of an agreement not to solicit customers:

Employee agrees that during his employment with the company and for a period of one year following any voluntary termination by employee of such employment or any termination of such employment by the company for just cause, he or she will not, on behalf of himself or on behalf of any other person, firm or corporation, call on or solicit in any manner any customer of the company with which the employee has had any dealings of any kind or upon whom employee called during the course of employee's employment by the company for the purpose of doing business of the type done by the company with such customer.

A non-solicitation of customers provision raises some genuine concerns for the employee in terms of future employment. It really is a non-compete, and it is worth negotiating to restrict the scope, duration and breadth of such a cause.

C. Non-Compete Agreements

A non-compete agreement may also go beyond the non-solicitation of customers and directly limit the activities which the departing employee can engage in and/or the employers for whom the departing employee can work. For example, a non-compete agreement may include a provision that the employee will not teach dance classes or will not produce tv shows or will not manage a restaurant in a certain area. A broad non-compete may preclude the employee from working in any capacity with an employer who competes in any area in which the employee's former employer. It is these agreements that are particularly problematic for the departing employee. While these agreements may be struck down by a court, a far better approach than signing and then hoping for the best is for the employee to use this risk of unenforceability to negotiate an agreement that leaves the employee free to pursue new opportunities, when he leaves his current employment.

While there may be an argument that the employee should just let the employer come up with an overly broad non-compete agreement and then challenge that agreement when the employer tries to enforce it, this can be a very dangerous approach. First of all, a prospective employer will be reluctant to hire that employee, with a non-compete hanging over his or her head since the new employer may be liable on a tortious interference claim. Second, even if the employee wins the litigation, the employee will have to spend significant attorneys' fees litigating the issue. Third, the case law in this area is horribly inconsistent and it is impossible to predict where a court will come out on any particular restrictive covenant.

D. Covenants Not to Compete Entered into at the Time an Employee Is Terminated

Very often, as attorneys representing employees, clients come to see us who are asked, for the first time, to enter into a restrictive covenant at the time they are terminated. This covenant is requested in exchange for a severance payment. While there has not been a lot of litigation on this issue, there is some authority that such agreements are simply not enforceable.

In Gorman Publishing Company v. Stillman, 516 F.Supp. 98, 108 (N.D. Ill. 1980), the court noted as follows:

It is axiomatic that an agreement in restraint of trade is not enforceable and thus ancillary to an otherwise valid contract. Restatement of the Law of Contract, Section 515. It is an obvious corollary of this proposition that where, as here, a covenant not to compete is entered into after the underlying employment relationship is terminated, no enforceable rights arise.

Gorman still appears to be good law, although there does not appear to be much case law on this issue. While, again, an employee has the option of signing and then hoping the agreement either won't be or can't be enforced, I think it is preferable to use the questionable enforceability of such agreements as leverage to get them taken out of the severance agreements.

III. THE EMPLOYEE WISH LIST: IF I HAVE TO SIGN THIS, COULD IT INCLUDE _____?

A restrictive covenant will generally include the following provisions: statement of consideration for the covenant; statement of the employer's business interests; definition of the scope of the covenant; a modification/severability clause; an agreement as to what state law controls; a provision of remedy; an integration clause and an assignment clause. I have not addressed all of these because many of them don't matter to employees. The following is a list of provisions (some of which likely won't appear on the employer's draft) that an employee probably wants in the agreement.

A. No Non-Compete In Event Of Termination Without Cause Or Employee Leaving For Good Reason

One of the most important provisions for an employee to seek is one that ensures that if the employment is terminated by the employer without cause, or by the employee for good reason, then the non-compete clause does not apply.

Good reason might include a material diminution in the employee's title, duties, responsibilities, authority, compensation or benefits; the requirement to relocate beyond a certain area; the employer's breach of contract; or a change in control.

In defining just cause, the employee's lawyer, of course, wants to make the definition as narrow as possible. Typical elements of cause include conviction of a felony, loss or suspension of any necessary licenses, breach of company policy; failure or refusal to perform the duties of the job; insubordination; and breach of contract by the employees. The employee's lawyer wants to use words like material or substantial before words like breach. In addition, the employee wants a provision requiring the employer, before terminating the employee for cause, to give the employee adequate written notice of the proposed action and a reasonable opportunity to cure. This cure provision, of course, need not apply to grounds that are not curable, such as conviction of a felony or loss of a necessary license.

There is also law that an employer who terminates an employee without cause generally cannot enforce a covenant not to compete against that employee. See, e.g., Post v. Merrill, Lynch, Pierce, Fenner & Smith, 397 N.E.2d 358 (N.Y. 1979). In Illinois, an employer who terminates the employment relationship, even without cause, can still enforce the covenant, unless the termination is a result of bad faith on the part of the employer. See Rao v. Rao, 718 F.2d 219, 224 (7th Cir. 1983).

Recent case law in Illinois suggests that a termination by the employer, without just cause, may be a factor the courts consider in determining whether to uphold the restrictions in the covenant. The Illinois court noted in Woodfield Group, Inc. v. Durial, 295 Ill.App.3d 935, 943 (1st Dist. 1998) noted that factors such as whether the employee or the employer terminated [the] employment, may need to be considered to properly review the issue of adequate consideration to uphold the covenant not to compete.

There is, however, clear case law in Illinois that if the employer violates the contract first, in some material respect, for example, by terminating an employee without cause, contrary to the contract terms, the employee has a defense to any alleged breach by the employee of a covenant not to compete. See, e.g., Gailsburg Clinic Association v. West, 302 Ill.App.3d 1016, 1018 (3rd Dist. 1999).

B. Duration of Non-Compete Linked to Severance

Another clause that an employee may want is one linking the duration of the non-compete period to severance pay. An even better alternative would be to give the employee the option of shortening the non-compete period by ceasing or waiving severance payments. An argument employee's counsel can make in favor of this is that, from the employer's perspective, this link helps to show that the length of the restriction is reasonable.

C. A Narrow Scope

There are three areas in which a non-compete can be narrowed: geography, time and activity. Under Illinois law, the permissible scope of a non-compete depends on what the employer's protectable interest is. The permissible protectable interest of an employer to justify a non-compete is as follows:

Generally, there are two situations in which a legitimate business interest will exist: (1) where the customer relationships are near permanent and but for the employee's association with the employer, the employer would not have had contact with the customers; and (2) where the former employee acquired trade secrets or other confidential information through his employment and subsequently tried to use it for his own benefit.

Lawrence & Allen, Inc. v. Cambridge Human Resource Group, Inc., 685 N.E.2d 434, 443 (2nd Dist. 1997).

In terms of geographic restrictions, therefore, courts generally look to whether the restricted area is co-extensive with the area in which the employer is doing business. Lawrence & Allen, Inc., 685 N.E.2d at 442. In assessing the reasonableness of the temporal scope of a non-competition or a non-solicitation agreement, courts generally look to things such as the time it takes to acquire and maintain clients. See, e.g., Midwest Tel, Inc. v. Oloffson, 699 N.E.2d 230, 235 (3rd Dist. 1990).

In reference to scope of activity restrictions, a non-competition agreement which restricts a specific activity, such as soliciting particular clients or doing a particular job, is subject to a lower degree of scrutiny than an agreement which prohibits the employee from engaging in any type of competition with the employer. Abbott-Interfast Corp. v. Harkabus, 619 N.E.2d 1337, 1341 (2nd Dist. 1993).

As David Carr notes in his paper, overreaching on length, geographic scope and/or restricted activities, is one of the ten biggest mistakes employers make in the area of non-compete agreements. It is one of the biggest reasons that covenants not to compete are found by courts to be unenforceable. This concern on the part of the employers should give some leverage to employee or employee's counsel in negotiating these aspects of the agreement.

D. Fair Remedies

Employers often like to include a liquidated damages provision for breach of the non-compete obligations. The employee should try to resist a liquidated damages provision and/or insist that liquidated damages should apply to any material breach by either party of any aspect of the employment agreement.

One remedy the employee should seek is that, in the event of any litigation relative to the non-compete agreement, the court or arbitrator should have the power to award attorneys' fees to the prevailing party.

F. Fair and Affordable Dispute Resolution

This is an area in which the employee may be more than willing to consider non-judicial resolution of disputes. Arbitration of contractual disputes generally has many advantages for employees, including speed, cost and finality. The supposed advantages of a jury trial are less applicable in contract disputes.

However, there are subsidiary issues that may be important. First, it is in an employee's interest to have an employer bear all or most of the cost of such proceedings. The cost of arbitration, if the employee has to share the cost of the arbitrator, can be quite significant.

A second issue is location. Obviously, it is preferable to have the location specified as where the employee lives and works.

In addition, it makes sense to have a three-step dispute resolution provision, which includes good faith discussions, mediation and then arbitration.

Finally, as noted above, it is in the employee's interest to give the arbitrator authority to award attorneys' fees to the prevailing party. Absent such a provision, arbitrators generally lack the

authority to award attorneys' fees to a prevailing employee in a contract dispute. This disadvantages the employee more than the employer. The threat of having to pay for an attorney, even if the employee wins, can put the employee in the position of adhering even to a completely overbroad and unenforceable restrictive covenant. On the other hand, a provision requiring the arbitrator to award attorneys' fees to the prevailing party creates a risk that the employee may have to pay the employer's attorneys' fees. The best balance is for the agreement to enable, but not require, the arbitrator to make such an award.

CONCLUSION

As a lawyer representing employees, we rarely get asked to participate in drafting restrictive covenants. However, where those opportunities do arise, we can and should push for an agreement that will protect the employee when and if the employment relationship ends.