Resolving Disputes: Covenants Not to Compete

By Amy Lieberman

When an employee suddenly leaves and threatens to establish a competing business – soliciting employees and customers - many business owners feel compelled to go after the renegade employee. Along with anger and a deep sense of betrayal, there is a strong fear, or knowledge, that the employee took confidential information – intending to use it to his advantage and the detriment of the former employer.

The first thing a lawyer does is look to see if there is a contract with restrictive covenants, such as covenants not to compete, non-solicitation covenants and covenants to preserve confidential information.

The second step is to determine and advise as to whether the covenants are written in such a way as to be enforceable, under applicable law. In California, for example, covenants not to compete are unenforceable by statute. In Arizona, the covenant may be enforceable to the extent necessary to address a legitimate business interest. Reasonableness in terms of geographic scope and length of time will be a factor in determining enforceability.

Often, the renegade employee claims that he was told by a lawyer, **"Oh, don't worry, that covenant will *never* be enforced!"** However, rarely is enforceability that black-and-white.

With the downturn in the economy, more restrictive covenant claims appeared before me in both arbitration and mediation. Several key learning points emerged:

1. By the time the clients get to mediation, large sums of money have already been spent on legal fees. Declaratory relief, in the form of a preliminary injunction, may have been sought. These hearings are fast and furious, requiring long hours, and resulting in high bills early on. Such fees are not budgeted for, and can be overwhelming for a small business.
2. It is important for companies to aggressively pursue those who they believe are violating their contracts. Other employees who may be contemplating similar action need to know the company is not afraid to pull out all the stops and pursue legal action. The message to be sent is: ***Violate your contract, and we will sue you! You will pay one way or the other.***
3. By the time the parties get to mediation, the message has been sent. Hopefully, the deterrent effect will have worked on future employees. It's time to resolve the dispute.
4. Damages are hard to prove or sometimes even to estimate. Can the employer show what business has in fact been lost and diverted? Can they prove that it was due to the renegade employee's actions? Due to the difficulty in proving up claims, rarely are large sums of money spent on substantive resolution.
5. The uncertainty of who the prevailing party may be and the risk that the party will not only have to pay their own legal fees but those of the other side is unsettling to many clients.
6. The departing employee should know that her ***former*** employer may seek to assert claims against her ***new*** employer, who knowingly or unknowingly benefits from the employee's information. The last thing a company wants is to hire someone and bring a lawsuit on themselves. This is not a good way to start with a new employer.
7. The contract dispute between the employee and the former employer may be in arbitration due to a ***contractual*** agreement to arbitrate, but the former employer may have ***tort*** or ***statutory*** claims against the ***new*** employer that are asserted in court. The issues are similar to those in arbitration. You may well be facing litigation on the same facts in two different arenas, judicial and arbitral. This results in costly duplication of effort, with potentially inconsistent results. Will estoppel principles apply? Which rulings prevail?
8. Customers and potential clients may be lost because they are turned off by the dispute, and do not wish to be caught in the middle. As a result, they go with a third competitor. Both parties lose.

The good news is that solutions can be creative. The length of a non-compete can be shortened. The geographic scope can be redefined. Non-solicitation of employees and/or customers can be negotiated. A complete release from a non-compete can be accomplished, in return for payment of legal fees. Mutual walk-away can also be the end result.

So what's the bottom line? Send the cease-and-desist letter, and, absent quick compliance, file and serve the lawsuit. However, be sure your client has reasonable expectations about the fact that these cases lead to large legal bills early on that can be a challenge to recover, absent a huge victory in court far down the road. Once the message has been sent, work to get into mediation for an efficient resolution.

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