EimerStahl LLP

February 2019
EimerStahl Newsletter

HIRING FROM COMPETITORS

PRACTICAL WAYS TO REDUCE RISK AND PREPARE FOR LITIGATION

By Alec Solotorovsky and Caroline Malone

RESTRICTIVE COVENANTS - THEORY AND PRACTICE

Businesses often hire employees from their competitors, which can trigger litigation based on a restrictive covenant agreement or a trade secret misappropriation theory. Post-employment restrictive covenants are commonly known as “noncompetes,” but they also include nonsolicit agreements (preventing the employee from soliciting customers, employees, or even vendors and other business partners) and nondisclosure agreements (preventing the employee from disclosing confidential information). Typically, the former employer will sue both the employee and the new employer based on breach of contract, tortious interference with contract, and trade secret misappropriation theories, and will seek a preliminary injunction barring the employee from working during the litigation, which may last months or even years.

This litigation is expensive and disruptive even in cases where the defendants prevail and, as a practical matter, the outcome of the preliminary injunction hearing – essentially, a mini-trial held soon after the case is filed to determine whether the employee should be barred from working during the litigation – often determines the outcome of the dispute. If a preliminary injunction is denied, the former employer will often drop the lawsuit or settle in exchange for token restrictions on the former employee’s activities going forward.

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If a preliminary injunction is granted, the defendants may feel compelled to part ways rather than continue to litigate while the employee sits out – the employee because of the career risk posed by an indefinite period of inactivity and the employer because it cannot await the outcome of a trial to fill an important position. At minimum, after issuance of a preliminary injunction, the defendants will have to agree to meaningful activity restrictions, and perhaps a substantial payment of money, to obtain a settlement that allows the employee to keep working in some capacity.

Thus, when hiring from competitors, a business should consider not just the background law and the text of the employee's contracts, but also the facts and circumstances that a judge would consider in ruling on a motion for preliminary injunction. The new employer should not assume that no lawsuit will be filed, or that it will quickly prevail in a lawsuit, based on: (1) technical defects in the restrictive covenant agreement; (2) the fact that other employees have left the same employer without a lawsuit being filed; (3) the former employer's assurances to the employee that the restrictive covenants were boilerplate; or (4) the existence of a plausible argument that the employee will not threaten the former employer in his new role. All of those things are relevant, but should not be relied on to the exclusion of actually assessing the risk and preparing for litigation.

Restrictive covenant cases are often filed in state court, often in the former employer's home jurisdiction. Even contracts with mandatory arbitration provisions typically allow the employer to sue in court to seek an injunction against the threatened breach of post-employment restrictive covenants. Most jurisdictions nominally disfavor post-employment restrictive covenants and enforce them only to the extent necessary to protect a "legitimate economic interest" of the former employer, such as strategic plans, proprietary technology, or long-term customer relationships. *See, e.g., Lyons Ins. Agency, Inc. v. Wilson,* 2018 WL 4677606, at *5 (Del. Ch. Sept. 28, 2018). However, many courts lack the commercial sophistication to effectively scrutinize both the reasonableness of the post-employment restrictive covenants (*i.e.,* whether they protect the legitimate interests of the former employer or restrict competition *per se*) and the former employer's claim of an imminent competitive threat. They may, therefore, reflexively favor the former employer, especially since in many cases the employee will have actually breached his contract by working for a competitor and must argue that the contract is unenforceable, or not fully enforceable, on the facts of his case. Although in many cases that argument is right, it can easily be lost on a judge who believes the employee must be held to his contract simply because he signed it.

RISK FACTORS TO CONSIDER BEFORE HIRING

Below are several factors the new employer should consider in assessing litigation risk when hiring from a competitor. The presence of some, or even all, of these factors does not necessarily mean the employee cannot be hired, but indicates a likelihood of litigation that the new employer should prepare for beginning as early as possible. Restrictive covenant litigation moves fast and, in order to reclaim the initiative from the former employer and defend against a motion for preliminary injunction, the new employer must quickly respond with a clear explanation of the law disfavoring restrictive covenants and a clear counter-narrative showing that the defendants – not the former employer – are the innocent parties who deserve the court's protection. In a jurisdiction where the law does not disfavor restrictive covenants, the defendants will have to focus on the demanding standard of proof for issuance of a preliminary injunction and argue harder that the former employer will not be irreparably harmed if the employee is allowed to work pending a trial.

1. **Seniority: VP/Director/Manager/Partner**

Courts are more likely to enforce restrictive covenants against senior-level employees because they are perceived as having had greater access to sensitive information and relationships of the former employer, greater bargaining power in the initial negotiation of the restrictive covenant agreement, and greater moral fault in accepting a position with a competitor in violation of the agreement. In a preliminary injunction proceeding, a senior-level employee will also have a harder time arguing hardship if she were enjoined from working, both because of having made more money over her career and having varied employment options that might *not* require working for a competitor in violation of her agreement. Moreover, from a practical standpoint, every trial is, in part, a David and Goliath story, and a more senior employee will have a harder time presenting herself as the underdog in a fight against the former employer.

"…every trial is, in part, a David and Goliath story…"

2. **Function: Executive/Technology/Sales**

Unlike ordinary contracts, in most jurisdictions restrictive covenants are enforced only to the extent necessary to protect a legitimate economic (or "business") interest of the former employer – not to prevent competition *per se*. The legitimate economic interests commonly asserted by employers and recognized by courts are the protection of sensitive business strategies, proprietary technology, or long-term customer relationships to which the former employee was given access. Thus, executives, technology workers, and customer-facing sales people are higher-risk hires.

3. **High Compensation; Equity and Incentives**

Compensation *per se* does not affect the enforceability of a restrictive covenant or the proof required for a preliminary injunction. However, in the case of a highly-compensated employee, the former employer will tell the court a story of commitment and betrayal that may bias the court against the defendants unless overcome by a clear counter-narrative regarding the employee's market value and his legitimate reasons for leaving. Moreover, a significant portion of incentive compensation, especially equity or equity-like compensation, will be viewed as evidence of a trusted senior employee who was more likely to have access to sensitive information and is morally more at fault for accepting a position with a competitor in violation of a contract. The employee's compensation, if substantial, and especially if including severance during the noncompete period, also bears on the hardship the employee will suffer if enjoined from working, which is a factor considered by courts in almost all jurisdictions. The richer the employee, the less her hardship in having to sit out pending the outcome of the litigation.

4. **History with Competitor**

A longtime employee of the former employer, especially a founder or an employee responsible for innovating a valuable strategy, technology, or line of business, will be more easily portrayed as having access to competitively sensitive information of the former employer. An employee of very short duration will be more easily portrayed as disloyal and is more likely to be sued by the former employer due to the lack of longstanding personal relationships that can, in some cases, be the basis of a negotiated resolution.

5. Similar Roles

The more similar the employee's new role to his old role, the greater the likelihood of a lawsuit and the better the former employer's chances of winning a preliminary injunction. In a substantially similar role, the employee will be more easily portrayed as relying on sensitive information gained from the former employer and arguably will inevitably disclose sensitive information, which in rare cases can be the basis of an injunction even absent a restrictive covenant agreement. Where the employee is expected to solicit employees or clients of the former employer, or implement a strategy or business of the former employer, the risk is greater, due to the greater likelihood of the employee's using information of the former employer for those purposes and the existence of a more immediate threat to the former employer.

6. Significant Compensation Increase

Like the employee's compensation at the old firm, the employee's compensation at the new firm does not directly affect the enforceability of restrictive covenants. However, a significant increase that appears out of proportion to the employee's market value may be taken as evidence of the new employer's intent to gain access to a competitor's sensitive information or client relationships by hiring the employee. The new employer should be prepared to explain the employee's compensation based solely on the market value of her general skills, knowledge, and experience – not information or relationships gained from the former employer.

7. Sponsor-Backed Competitor

Firms of all kinds litigate restrictive covenant agreements. However, based on experience, sponsor-backed firms are more likely to aggressively litigate against a former employee who leaves for a competitor. Sponsor-backed firms generally have restrictive covenant agreements with all senior employees and others having any access to customers or sensitive information, to better position a company for future sale. Private equity sponsors often aggressively enforce those agreements, based on the belief that aggressive enforcement is necessary to protect an investment, to demonstrate vigilance to prospective buyers of a company, or to protect the sponsor's own reputation in the marketplace. Thus, even in situations where other employers might refrain from enforcing a departing employee's restrictive covenants due to the cost and distraction of litigation, a sponsor-backed firm may file a lawsuit.

8. Restrictive Covenant Agreement

Not all employees have restrictive covenant agreements. In rare cases, even senior executives may not have restrictive covenants in place as of leaving, *e.g.,* due to disagreements over a grant of equity that delay finalizing an employment contract. Employees who do have restrictive covenants present higher litigation risk because they can be sued based on both a breach of contract theory and a statutory trade secret misappropriation theory, and the new employer can be sued based on a tortious interference theory. Absent a restrictive covenant agreement, the plaintiff is limited to a trade secret misappropriation theory, which offers a narrower path to a preliminary injunction.

9. Jurisdiction

Although most jurisdictions nominally disfavor restrictive covenant agreements, judicial attitudes vary widely both as a matter of law and practice. For example, courts in Florida often issue preliminary injunctions in restrictive covenant cases based on a statute that directs them to presume irreparable harm

from the breach of a restrictive covenant and disregard hardship to the former employee. Fla. Stat. Ann. § 542.335; *Smart Pharmacy, Inc. v. Viccari,* 213 So. 3d 986, 988 (Fla. Dist. Ct. App. 2016). This statute puts a thumb on the scale in favor of the former employer. In contrast, under California law, restrictive covenants are generally unenforceable, subject to certain exceptions. Cal. Bus. & Prof. Code § 16600. (For instance, California courts will enforce restrictive covenants signed in connection with the sale of the goodwill of a business. Cal. Bus. & Prof. Code § 16601.) California courts also will generally not enforce restrictive covenants entered into in another state, based on public policy considerations. *Application Grp., Inc. v. Hunter Grp., Inc.,* 61 Cal. App. 4th 881, 72 Cal. Rptr. 2d 73 (1998).

Other jurisdictions fall in between these extremes; however, the commercial sophistication of the local courts, or lack thereof, presents risk to the defendants even where state law directs the court to carefully scrutinize restrictive covenants and apply a demanding standard of proof to a motion for a preliminary injunction. In jurisdictions where courts rarely adjudicate complex business disputes, the court will be more likely to accept the former employer's arguments about the reasonableness of the restrictive covenants and the competitive threat posed by the defendants, at least in the early going. In other jurisdictions where the courts regularly adjudicate complex business disputes, the defendants can be more confident of the judge, but the facts may still favor the former employer.

The new employer should assume that a lawsuit will be filed in the forum provided for in the employment agreement, if it contains a mandatory forum selection provision. Absent such a provision, the lawsuit will likely be filed in the former employer's or the employee's home jurisdiction, depending on which is more favorable to the former employer.

HOW TO REDUCE RISK

Careful planning can reduce the risk of a lawsuit and better position the defendants to prevail in a preliminary injunction proceeding, which is critical to a positive early resolution. The new employer's top priority, throughout the hiring process and pre-lawsuit interaction with the former employer, should be to preserve credibility with the judge who will rule on a motion for preliminary injunction. That does not mean the new employer must avoid hiring employees subject to restrictive covenants or restrict an employee's activities to the point that she cannot be useful to the new employer – it means the new employer must (1) have a defensible basis for disregarding an employee's restrictive covenants; (2) comply with all contract provisions *other than* restrictive covenants of questionable enforceability; and (3) be truthful in communications with the other side and preserve evidence likely to be requested in litigation.

1. Review Agreements

Review all agreements signed between the employee and the former employer to assess the scope and enforceability of restrictive covenants. Sometimes, the restrictive covenants are narrow enough to work around in designing the employee's new role. More often, the restrictive covenants are overly broad and the new employer should consider creating a role for the employee that would avoid violating a narrower restrictive covenant that a local court would be likely to enforce. This requires analysis of state law and prior cases.

Sometimes, the employee will have no restrictive covenants at all. However, even where an employment agreement lacks post-employment restrictive covenants (or where there is no employment agreement in

place), the new employer should review all documents signed between the employee and the former employer. Restrictive covenants sometimes appear in offer letters, documents granting equity or equity-like compensation, documents signed in connection with a promotion, or employee handbooks. (Employee handbooks typically provide that the handbook is *not* a contract, but absent any better document, an aggressive former employer may nevertheless assert that it is.) In a case with no restrictive covenants, the new employer should still consider the risk of a lawsuit based on a statutory trade secret misappropriation theory.

2. Design Job Title and Function

If possible, give the employee a different job title than at the former employer and a different job function that will enable the defendants to credibly argue that the employee can fulfill his duties to the new employer without relying on information learned at the old employer. If this is not possible, be prepared to demonstrate that the businesses of the old and new employer are sufficiently different – *e.g.,* based on territory, lines of business, client focus – that the employee can perform the same job for the new employer without threatening the old employer. As a practical matter, hiring a senior employee from a competitor, who is subject to a noncompete, to perform an identical or substantially similar job for the new employer, will be difficult to justify to most judges. In those situations, a compelling argument that the old and new employer do not directly compete, despite being in the same industry, may at least prevent the issuance of a broad preliminary injunction and thereby create an opening for a tolerable settlement.

3. Customer and Employee Interaction

Consider restricting the employee's contact with customers and employees of the old employer (or customers in general, if possible) for a period of time post-transition. The time period may be based on the length of a nonsolicit provision in the employee's contract, if there is one, as nonsolicits are more likely to be enforced as written than noncompetes. Restricting contact with customers and employees of the former employer reduces the likelihood of the employee using confidential information of the former employer, eliminates a competitive threat, and shows the new employer's good faith.

4. Notice to Competitor

If the employee is contractually required to notify the former employer of her new place of employment, give the required notice. Do not counsel the employee to deceive the former employer about her new position. Instead, operate on the assumption that the former employer will quickly learn about the new employer through mutual acquaintances in the industry. The notification process is an opportunity for exploring a negotiated resolution and, at minimum, allows the defendants to demonstrate good faith to the court in the event of a lawsuit.

5. Competitor's Documents and Information

Counsel the employee to meticulously comply with all contract provisions requiring the return of company documents, information, equipment, etc. Encourage the employee to search his house, car, personal computer, and other locations for company documents and return all of them. The employee should take nothing from the former employer without permission except his family photos and personal trinkets. Include a provision in the employee's offer letter and employment agreement stating that the new employer does not want any information belonging to an old employer and that bringing such information to the new employer may be grounds for termination. Those documents will be produced to the former employer in litigation and including such provisions allows them to be used offensively by the defendants.

"take nothing from the former employer without permission"

6. Preserve Evidence

If litigation is anticipated, preserve documents and communications regarding the employee's hiring and counsel the employee to do likewise. These documents will be requested promptly after the filing of a lawsuit and, if any are lost or destroyed, the court will be highly suspicious of the defendants for the remainder of the litigation. Use caution when exchanging emails with the employee before and after the transition and in internal emails about the hiring process. Operate on the assumption that all non-privileged emails about the hiring will be discoverable.

7. Demand Letter Response

Typically, the former employer will send a demand letter to the defendants seeking information about the employee's new role, demanding assurances regarding the protection of its confidential information and, in some cases, making demands that the employee cease certain activities or stop working entirely. How to respond is a matter of judgment, but any response should be completely truthful. Assume that, in litigation, the employee's role and activities will be quickly discovered through documents and depositions and may already be known to the former employer through industry sources or its examination of the employee's data remaining on company computers. The new employer need not provide all (or any) of the information and assurances sought by the former employer, but the response will be evidence in litigation and it should be drafted so as to support the new employer's credibility in the eyes of a skeptical judge.

8. Plan for Litigation

In a scenario where many risk factors are present, consider having counsel on standby to respond to litigation. Counsel should have the resources to quickly brief a response to a motion for preliminary injunction explaining the law on post-employment restrictive covenants; conduct discovery aimed at undermining the former employer's "irreparable harm" argument; prepare the employee and other defense witnesses to testify; and effectively present evidence at a preliminary injunction hearing. Where the case is likely to be filed in a jurisdiction without significant experience in complex business disputes, consider adding a respected local lawyer who has established credibility with the court, even where that lawyer lacks the resources or experience to be lead counsel.

CONCLUSION

Restrictive covenant agreements need not prevent a business from hiring an employee from a competitor, but they should not be lightly dismissed as unenforceable or unlikely to be enforced. In practice, despite law in most jurisdictions that disfavors restrictive covenants, many employers aggressively enforce them and many courts are receptive to the former employer's arguments. To respond effectively, retain the employee, and minimize expense and disruption, the new employer should carefully assess the risks and conduct the hiring and transition process so as to best position itself and the employee to defeat a motion for preliminary injunction.

Ryan Walsh has joined Eimer Stahl LLP as Of Counsel. Previously the Chief Deputy Solicitor General of Wisconsin, a law clerk to U.S. Supreme Court Justice Antonin Scalia, and Editor in Chief of the University of Chicago Law Review, Ryan will focus his practice on complex and appellate litigation. Ryan is a Wisconsin native and will split his time between Chicago and a Madison office the firm is in the process of opening.

Pro Bono Win: Eimer Stahl LLP, along with attorneys from two legal aid organizations, saved a Chicago elementary school from being shut down. In February 2018, the Chicago Public Schools ("CPS") approved a plan to close the National Teachers Academy ("NTA"), a high-performing elementary school with a predominantly African American student body, and convert the campus to a high school. Eimer Stahl LLP attorneys Brent Austin and Caroline Malone represented a group of NTA families in a lawsuit to block the closure, arguing that CPS relied on racially discriminatory metrics and improper academic criteria in deciding to close NTA. On December 4, 2018, a Cook County judge enjoined the closure and CPS abandoned the plan.