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Restrictive Covenants: The Law In Flux

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Restrictive covenants in employment agreements are commonplace. But employers should be wary of simply recycling boilerplate contract language that has been successful in the past. The rules for testing the legality of restrictive covenants vary greatly among states, and are not fixed within states: statutes are periodically amended by state legislatures, and court decisions regularly alter the common law. Recent decisions from several courts illustrate the point, both with respect to the framework for considering such covenants, and specifically regarding the reformation of overbroad covenants.

Varied Legal Frameworks Governing Restrictive Covenants

States vary in their acceptance and treatment of restrictive covenants. In some states, noncompetition provisions are prohibited unless they fall within narrow statutory exceptions. California Business and Professions Code § 16600, for example, provides that: “Except as provided in this chapter, every contract by which anyone is restrained from engaging in a lawful profession, trade or business of any kind is to that extent void.” Colorado similarly bars, with narrow statutory exceptions, “[a]ny covenant not to compete which restricts the right of any person to receive compensation for performance of skilled or unskilled labor.” Colo. Rev. Stat. § 8-2-113(2). Other states follow the common law rule and allow such provisions. In these states, courts typically will consider the reasonableness of the restraints, including their duration and geographic scope, the activities banned, whether the employee receives adequate consideration in return for signing the agreement, and whether the restraints protect the legitimate needs of the employer.

Some state laws are pro-employer; others are pro-employee. One thing, nevertheless, is clear: the law has to be closely monitored, because it changes. For example, in Golden v. California Emergency Physicians Medical Group, 782 F.3d 1083 (9th Cir. 2015), the Ninth Circuit recently held that the

limitations on restrictive covenants imposed by Section 16600 extended beyond noncompetition agreements, a question that had not been resolved by California state courts. The court of appeals concluded that the statutory language, which reaches "every contract by which anyone is restrained," and extends to any "restraint of a substantial character," must be broadly construed. Id. at 1092-93. The court, accordingly, ruled that a no-employment provision in a settlement agreement that resolved a discrimination suit was void under California law.

In another recent case of first impression, the Pennsylvania Supreme Court allowed an employee to challenge, for lack of consideration, a restrictive covenant entered into after the employment began. The majority held that additional consideration (e.g., a promotion or change in pay) is required for restrictive covenants executed after employment commences. This is true even though the parties expressly averred that they "intend to be legally bound" by the agreement, a term that triggers the protections of the Uniform Written Obligations Act. Socko v. Mid-Atlantic Systems of CPA Inc., 126 A.3d 1266 (Pa. 2015).

The Evolution of the Law Regarding Reform of Overbroad Covenants

One of the many evolving areas of restrictive covenant law concerns what discretion, if any, a judge has to alter covenants that as written are not enforceable under state law. Many states permit "blue penciling," which allows the court to strike the offending language and enforce the remaining provisions, if they can logically stand alone; in these states the court cannot rewrite the provisions.[1] Others allow a court to rewrite the provisions, or even statutorily require that overbroad provisions be equitably reformed. Still other states do not allow any alteration of offending clauses, rejecting both the blue pencil rule and the more liberal rule permitting partial enforcement. In Virginia, for example, if the restrictive covenant violates state law by being unreasonably broad, a court will not enforce it.[2]

In some jurisdictions it is unclear what the applicable rule is. For example, while Washington, D.C., long ago rejected an all-or-nothing approach, see Ellis v. James Hurson Assocs., 565 A.2d 615 (D.C. Ct. App. 1989), it has yet to decide which contract reformation doctrine to follow. Delaware courts have modified covenants to make them reasonable, see, e.g., Knowles-Zeswitz Music Inc. v. Cara, 260 A.2d 171 (Del. Ch. 1969); WebMD Health Corp. v. Dale, 2012, at *9 (E.D. Pa. Aug. 10, 2012) (applying Delaware law and observing that "Delaware courts themselves 'blue pencil' restrictive covenant agreements that may be otherwise unenforceable, if the equities so dictate"). Some Delaware courts, however, now appear less steadfast. Vice Chancellor J. Travis Laster has observed that "a court should not save a facially invalid provision by rewriting it and enforcing only what the court deems reasonable. Doing so puts the employer in a no-lose position. If an employer knows that the court will enforce a reasonable covenant as a fallback, the employer has every reason to start with an overbroad position." Delaware Elevator Inc. v. Williams, 2011, at *10 (Del. Ch. March 16, 2011).[3]

In DGWL Investment Corp. v. Giannini, No. 86470-VCP, (Del. Ch. Sept. 19, 2013), Vice Chancellor Donald F. Parsons, ruling from the bench on the plaintiff's application for a preliminary injunction, remarked that the court in Delaware Elevator "provided a well-reasoned argument for why Delaware courts should refuse to save overbroad restrictive covenants and let the risk of unenforceability fall on an employer rather than the employee," (Tr. 17).[4] Nevertheless, the court did not feel constrained to follow the Delaware Elevator decision, which it characterized as involving "a restrictive covenant agreed to by a low- to mid-level employee," with "obvious disparities in bargaining power," as opposed to the case before it, involving senior managers and "top dog executives," where "a corporate founder and CEO received $10 million in exchange for control of his company and his promise not to compete." Id.

In New York, the law seemed clear for a significant period. Sixteen years ago, in BDO Seidman v. Hirschberg, 93 N.Y.2d 382, 394 (1999), the New York Court of Appeals held that New York courts could sever and grant partial enforcement of overbroad provisions, i.e., "blue pencil" them, so long as the employer in good faith sought to protect a legitimate business interest and there was no "coercive use of dominant bargaining power, or other anti-competitive misconduct."

Recently, however, several New York courts, faced with overbroad covenants, declined to grant partial enforcement. In Brown & Brown Inc. v. Johnson, 980 N.Y.S.2d 631 (App. Div. 2014), the defendant was required on her first day of employment to sign an agreement containing a nonsolicitation clause barring her from soliciting or serving any of the employer's clients for a two year period after termination of employment, as well as a clause barring her from inducing other employees to leave. The agreement contained a Florida choice-of-law provision.

After being terminated, the defendant found work with a competitor of her former employer, where she serviced some of the plaintiffs' former customers. She was thereafter sued for breach of the restrictive covenants in her agreement. The Appellate Division held that the Florida choice-of-law provision was invalid, because it was "truly obnoxious" to New York public policy. Then, applying New York law, the court ruled that the agreement's nonsolicitation clause was overbroad. The court expressly rejected the argument that the court should blue pencil the overbroad restrictions.

The court observed that "[f]actors weighing against partial enforcement are the imposition of the covenant in connection with hiring or continued employment, as opposed to, for example, imposition in connection with a promotion to a position of responsibility and trust, the existence of coercion or a general plan of the employer to forestall competition, and the employer's knowledge that the covenant was overly broad." Id. at 640 (citations and internal quotation marks omitted). The court also rejected the plaintiff's contention that the court was required to partially enforce the covenant, even though the contract provided for partial enforcement in the event it was deemed overbroad.

The New York Court of Appeals agreed with the Appellate Division that the Florida choice-of-law provision could not be enforced. Brown & Brown Inc. v. Johnson, 25 N.Y.3d 364 (2015).[5] While the appellate court reaffirmed that New York courts have authority to "sever and grant partial enforcement of an overbroad employee restrictive covenant," id. at 371, it remanded for a determination whether the plaintiffs had engaged in overreaching. The court emphasized that restrictive covenants must be presented to employees in a noncoercive environment, and that New York courts would not blue pencil agreements to make them enforceable where coercion is found. Id. at 372.

In Veramark Technologies v. Bouk, 10 F. Supp. 3d 395 (W.D.N.Y. 2014), the U.S. District Court for the Western District of New York refused to partially enforce a noncompetition agreement governed by New York law barring a former employee from competing "anywhere in the world," because "[o]n its face, the noncompete is overreaching and coercive, and partial enforcement would not be appropriate." The court refused to blue pencil the overly broad noncompete, but severed and enforced the remaining restrictive covenants.

More recently, in Banner Industries of N.E. Inc. v. Wicks, 2016 (2d Cir. Jan. 25, 2016), the Second Circuit affirmed the district court's refusal to enforce a restrictive covenant, citing the New York Court of Appeals ruling in Brown & Brown. And in Aqualife Inc. v. Leibzon, 50 Misc. 3d 1206 (A) (Sup. Ct. Jan. 5, 2016), the New York Supreme Court held that partial enforcement of overbroad covenants was to be evaluated on a case-by-case basis, and that where there was "overreaching, coercive use of dominant bargaining power, or other anti-competitive misconduct," overbroad provisions will not be enforced. Id.

at *7 (citing Brown & Brown). The court found it "undisputed that the plaintiff, who was in a superior bargaining position, required the individual defendants to sign the independent business owner agreements and the salesperson agreements containing the restrictive covenants as a condition of their initial employment as salespeople." Id. Therefore, "after considering the relevant factors, the court finds that the plaintiff has failed to demonstrate that partial enforcement of the restrictive covenants is warranted." Id.

The takeaway from these decisions is that New York courts will not blue pencil overbroad restrictive covenants if employers are using their superior bargaining positions to force employees to sign agreements that are unreasonable under state law, a further refinement of principles first announced in BDO Seidman. Further, New York will not enforce choice-of-law provisions that offend New York public policy, thereby thwarting employer efforts to choose a favorable forum in which to litigate its breach of contract claims.[6]

Illinois court decisions with respect to modifying restrictive covenants have also evolved. The rule has been that "[i]n some circumstances, courts may choose to modify an overbroad restrictive covenant rather than invalidate it outright." Cambridge Engineering Inc. v. Mercury Partners 90 BI, Inc., 879 N.E.2d 512 (Ill. App. Ct. 2007). But the courts have also warned that "judicial reformation of restrictive covenants" "should be looked upon with suspicion" when the provisions are unconscionable, unreasonable or overbroad. Id. at 529. Where there are "significant deficiencies," rather than minor ones, and "drastic modifications" would be required and "would be tantamount to fashioning a new agreement," modification of the offending noncompetition provisions is inappropriate. Eichmann v. National Hospital & Health Care Services Inc., 719 N.E.2d 1141, 1149 (Ill. App. Ct. 1999).

Recently, applying these principles, the court in Assured Partners Inc. v. Schmitt, ___ N.E.3d. ___, 2015 (Ill. App. Ct. Oct. 26, 2015), concluded that the noncompetition, nonsolicitation and confidentiality provisions at issue in that case were unenforceable, since "the deficiencies here [are] too great to permit modification." Id. at *12. Moreover, despite a clause in the agreement permitting judicial modification in the event any provision was deemed overbroad, the appellate court refused to substitute reasonable restrictions to allow the covenants to be enforced. The court explained that "[i]n determining whether modification is appropriate, the fairness of the restraints contained in the contract is a key consideration." Id. (internal quotation marks and citation omitted).

Several other states have recently changed their approach to modification of restrictive covenants. The Indiana Court of Appeals recently narrowed the blue pencil doctrine, insofar as employee noncompetition agreements are concerned. In Clark's Sales & Service Inc. v. John D. Smith and Ferguson Enterprises Inc., 4 N.E. 3d 772 (Ind. Ct. App. 2014), the court recognized that Indiana had adopted the blue pencil doctrine (noting that Indiana courts "historically enforced reasonable restrictions, but struck unreasonable restrictions, granted they are divisible"), id. at 783, but declined to do so where excising provisions to make the language enforceable would have to be extensive and would have altered the meaning of entire paragraphs. Id. at 784–87. Since it could not easily redact the challenged language, the court refused to enforce the noncompetition clause. Id. at 784 ("[T]he restriction provided ... is written as an indiscreet whole. There is no clear separation of terms or clauses that were or could be intended to be excised from the whole without changing the entire meaning or import of the passage.") Accordingly, the court held that the blue pencil doctrine was inapplicable because it would produce an agreement the parties did not make.

By contrast, the rules applicable to modifying unacceptable restrictive covenants have been liberalized in Georgia. Under prior legislation, the "blue pencil" rule of severability did not apply to restrictive

covenants in employment contracts. See Boone v. Corestaff Support Services Inc., 805 F. Supp.2d 1362, 1369 (N.D. Ga. 2011). Under revised Georgia Code Ann. § 13-8-53, which went into effect on May 11, 2011, courts may modify an otherwise overbroad restrictive covenant in order to make it enforceable, so long as the modifications do make the agreement more restrictive with respect to the employee than it was under the original version. Ga. Code Ann., § 13-8-53(d); see also Ga. Code Ann., § 13-8-54(b); see Vulcan Steel Structures Inc. v. McCarty, 329 Ga. App. 220, 225 (2014).[7]

Accordingly, while restrictive covenants in employment agreements are a venerable protection for employers who seek to avoid potential disruptions to their businesses, employers should not take state law for granted and simply recycle boilerplate contract language that has been successful in the past, hoping that at worst an overbroad provision will be judicially reformed. Restrictive covenants are increasingly heavily scrutinized by the courts. They should be drafted narrowly and with an eye to state law, which is constantly evolving. Choice of law provisions, or "step-down" provisions which allow courts to modify offending language, may not be honored.

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[1] In Arizona, for example, courts are authorized to strike "broad, unreasonable provisions in an agreement while keeping in place less onerous, enforceable ones." Compass Bank v. Hartley, 430 F.Supp.2d 973, 981 (D. Ariz. 2006) (citation omitted). However, any judicial modification of a restrictive covenant beyond application of the blue pencil rule "is a 'significant' modification of that provision and cannot be tolerated." Valley Medical Specialists v. Farber, 982 P.2d 1277, 1286 (Ariz. 1999). ("Although we will tolerate ignoring severable portions of a covenant to make it more reasonable, we will not permit courts to add terms or rewrite provisions.") Similarly, under Maryland law, "blue penciling must be limited to the removal of offending language and cannot include the addition of words or phrases in an effort to make the restrictive covenant reasonable." Deutsche Post Global Mail Ltd. v. Conrad, 292 F.Supp.2d 748, 757–58 (D. Md. 2003); accord Allegis Group Inc. v. Jordan, 2014 WL 2612604 (D. Md. June 10, 2014).

[2] See Job v. Simply Wireless Inc., 2015 WL 9460562, at *4 (E.D. Va. Dec. 22, 2015) ("[T]he prevailing view is that Virginia adheres to an 'all-or-nothing rule' that holds overbroad covenants not to compete unenforceable in whole ... Virginia courts refuse to 'blue pencil' or rewrite such clauses so as to make them reasonable and enforceable.") (citing Lasership Inc. v. Watson, 79 Va. Cir. 205 (2009), 2009 WL 7388870, at *9 (Fairfax Cir. Ct. 2009) (collecting cases)).

[3] That same year, during oral argument in another restrictive covenant case, Chesapeake Insurance Advisors Inc. v. Williams Insurance Agency Inc., et al., No. 7126-VCN (Dec. 21, 2011), Vice Chancellor John W. Noble, speaking from the bench, cited Vice Chancellor Laster's position with approval, quoting directly from Delaware Elevator. Tr. 14. He observed that in Delaware, "there is something of a divergence of opinion" concerning the use of the blue pencil doctrine. Id. 15.

[4] Other courts and commentators have also made this point. See, e.g., Charles A. Sullivan, The Puzzling Persistence of Unenforceable Contract Terms, 70 Ohio St. L.J. 1127, 1151 (2009); Deutsche Post Global Mail Ltd. v. Conrad, 292 F. Supp. 2d 748, 754 n.3 (D. Md. 2003).

[5] The court observed: "Whereas Florida shifts the burden of proof after the employer demonstrates its business interests ... New York requires the employer to prove all three prongs of its test before the burden shifts ... Further, Florida law explicitly prohibits courts from considering the harm or hardship to the former employee ... This directly conflicts with New York's requirement that courts consider, as one of three mandatory factors, whether the restraint imposes undue hardship on the employee." Id. at 369–370 (citations and internal quotation marks omitted).

[6] In Brown & Brown Inc. v. Johnson, the court referred to three other states (Illinois, Alabama and Georgia) that had ruled that Florida law conflicts with state public policies governing restrictive covenants. In a recent Delaware decision, the Court of Chancery held that California's interest in preventing the enforcement of covenants not to compete, as codified in Cal. Bus. & Prof. Code § 16600, was greater than Delaware's interest in freedom of contract. Accordingly, the court invalidated the Delaware choice-of-law and venue provisions, striking a blow at the employer who had drafted those provisions expressly to circumvent California law. See Ascension Insurance Holdings LLC v. Underwood, 2015 WL 356002 (Del. Ch. June 27, 2015). On the other hand, in DGWL Investment Corp. v. Giannini, supra, the Court of Chancery held that while California had a significant interest in the case, it was not materially greater than Delaware's interest.

[7] The Georgia statute was drafted to permit the liberal enforcement of restrictive covenants against executives, but not against lower-level employees. See O.C.G.A. § 13-8-51.