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Creating and enforcing non-competes

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If you are a business owner that has invested resources in hiring and training your employees, or given them access to valuable proprietary information during their employment, then you should take some steps to protect that investment.

One way to protect your investment is through the use of non-compete agreements. Non-compete agreements become useful in two business scenarios: First, in hiring or terminating employees who will have or have had access to valuable proprietary information that would put your business at a competitive disadvantage if they used that information against your business. The second situation is in the purchase or sale of a business.

In either situation these agreements place restrictions on a person's ability to compete with an existing business. In the purchase and sale of a business, they are a necessity. They are commonly negotiated to give the buyer the assurance that the seller will not go out the day after the sale and start a competing business. Since most parties to a business sale are considered to be on equal footing in terms of the bargaining power, non-compete agreements in a business sale are given less scrutiny by courts than those for individual employees, who are generally not on an equal footing with their employer. However, non-compete agreements in a business sale should be carefully crafted and drawn. If the agreement is too broad in scope it may be considered an illegal restraint of trade and unenforceable as a matter of the public policy.

In the individual employee context, one might assume that non-compete agreements would also be considered unenforceable as an illegal restraint of trade. For many years that was precisely how Michigan courts interpreted them. However, most states laws now recognize that there is significant value in protecting an employer's legitimate business interests for the benefit of the owner and its other employees.

The current view is generally that public interest in free trade is served when the employer's legitimate business interests are balanced against the employee's interest in being able to earn a living using his or her talents. Michigan law, MCL 445.774a, specifically allows an employer to obtain from an employee a non-compete agreement which protects the employer's reasonable competitive business interests. These agreements can expressly prohibit an employee from engaging in employment or a line of business after termination of employment. Courts will enforce these agreements so long as they are reasonable in duration, geographic area, and the type of employment or line of business prohibited. With this Michigan law on the books it is easy to see why non-compete agreements are popular with employers.

However, care needs to be exercised in their drafting. If your agreement is too restrictive in any one of the three areas (duration, geographic area or line of business) the court may be inclined to not enforce the agreement at all. The law gives a court the authority to rewrite any agreement it finds to be unreasonable in duration, geographic area or line of business. Some courts have declined to exercise that authority, and have simply refused to enforce the entire agreement. The law says you can have a non-compete agreement that protects your "reasonable competitive business interests." Examples of legitimate business interests are: retaining clients and goodwill, protecting trade secrets or confidential information like cost factors, pricing information or client lists, or maintaining close contact with your customers.

A legitimate business interest must be something greater than protection from mere competition, because a prohibition against all competition is an illegal restraint of trade. What is "reasonable" is open to broad interpretation. You should start with the premise that you are trying to protect legitimate business interests. You are not preventing the employee from engaging in any work, just work that unfairly competes most directly with what he or she did for your business.

In crafting the non-compete agreement, start with the idea that you want to restrict competition by the employee using the skills, talents, experience and knowledge developed during employment with your business. Then the conditions of duration and geographic location should fall into place.

Reasonable duration and location have to be determined on a case by case basis. In terms of duration, courts generally allow anywhere from six weeks to six years, and more or less depending on the type of employment or line of business and geographic location.

If your business is regionally limited within a state, a statewide or nationwide prohibition is probably unenforceable. You might try trading off a shorter duration for a broader geographic location and vice versa. The key inquiries are: how did that employee conduct business for you and what are you trying to prevent? When crafting the essence of the agreement (line of business, duration, and geographic area) being reasonable gives you the best chances of getting the entire agreement enforced.

There are additional contractual terms that can put teeth into enforcing these agreements. In the appropriate case, making the non-compete agreement assignable to successors of your business adds value to the sale price of your business. The agreement should contain an acknowledgement that the employee is receiving valuable proprietary information and that a breach of the agreement will result in irreparable harm entitling your business to immediate injunctive relief. When attempting to enforce these agreements through a lawsuit, actual damages resulting from a breach can be difficult, if not impossible, to ascertain or prove early on. Liquidated damages provisions can be useful. They should not be structured as a penalty, but as compensation for the breach, and as payment for the training and experience obtained while in your employ. Here, again, the watch word is reasonableness.

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If the amount stipulated is reasonable in relation to the possible injury suffered, the courts are more likely to enforce the liquidated damages provisions. Start with a moderate lump sum, e.g. three month's salary, and add a daily damage calculation based on the employee's past compensation multiplied by the number of days of the breach. Another consideration is that you may not find out about a breach of the non-compete agreement for some time and may have to litigate to enforce the agreement.

To keep that period of breach or court time from being counted against the duration of the agreement, state in the agreement that the time period agreed to shall be extended to include the period of time during which a breach occurs, and any period of time required to litigate activities constituting a breach. Have the non-compete agreement provide for reimbursement of your reasonable attorney's fees and specify which state's law governs the agreement.

A trap for the unwary is the question of consideration for the agreement. To be enforceable, all contracts must be supported by legally recognizable consideration. When a non-compete agreement is signed before employment begins, the employment itself supplies the required consideration. However, some courts have questioned whether an existing employee confronted with the choice of signing a non-compete agreement or losing their job has received some bargained for consideration in exchange for their agreement.

Presently, in Michigan, it appears that continued employment for at-will employees is sufficient consideration. This may not be the case for employees under collective bargaining agreements or employment contracts providing for "just cause" termination.

Giving some additional consideration to existing employees in exchange for their non-compete agreement, even if nominal (for example one day of extra pay for every year of completed employment), is better than none at all.

With these points in mind, you should be able to create and enforce reasonable non-compete agreements that will add significant value to your business.

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