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Litigating Covenants Not to Compete

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Covenants not to compete in employment agreements are widely used and frequently litigated in Minnesota, as evidenced by the over 100 published and unpublished cases addressing the subject since the seminal case of *Bennett v. Storz*.[1] This article is based upon a review of all these cases, as well as the author's 16 years of practice experience in this area.

In deciding whether to enforce a covenant not to compete, Minnesota courts analyze the specific facts of each case to determine:

> 1. As a threshold matter, is there adequate consideration supporting enforcement of the noncompete? If not, the analysis ends immediately and the covenant will not be enforced.
>
> 2. Does the employer have legitimate business interests deserving of protection?
>
> 3. If the answer is "yes," what is the minimum restriction that can be placed on the employee that will protect those business interests while preserving the employee's ability to earn a livelihood? This requires an analysis of:

- The appropriate duration of the period of non-competition.
- The appropriate geographic limitation on the former employee's ability to compete.

Almost all noncompete cases are decided in the context of a motion for either a temporary restraining order (TRO) or a temporary injunction, both of which require application of the five-factor test established in the *Dahlberg Bros*. case.[2] Courts nearly always give greater weight to the second and third factors: balance of the harm and likelihood of success on the merits.[3] Courts must also find that the employer will be irreparably harmed in order to grant a TRO or temporary injunction enforcing a covenant not to compete.

This article will first review the three legal issues identified above and will then discuss irreparable harm and the two Dahlberg factors.

Consideration

A non-compete agreement signed before employment begins does not require independent consideration to be enforceable. However, if a purported agreement is signed after employment begins, it will be unenforceable absent independent consideration.[4]

It may not be enough -- i.e., it may be too late -- to present an employment agreement with a non-compete clause to the employee on his first day of work. This is especially true if the employee has quit another job, sold a home, or otherwise irreversibly changed her position after accepting the employer's offer.[5]

The one exception to the requirement of independent consideration after employment begins is seen in *Davies*. The Court there held that the continued employment in that case, which included promotions and pay increases, provided sufficient independent consideration.[6] The employee in *Davies* worked an additional 12 years after signing the non-compete agreement.

However, most courts have declined to find that continued employment provides independent consideration without bargained-for and new "real advantages."[7] The problem with broadly applying the reasoning in Davies is that employees receive promotions and pay raises because they earned them through hard work and outstanding performance. This was the reasoning in *Sanborn Mfg*., in which the court declined to enforce a non-compete signed after the employment began, because the court found no evidence that the employee's promotion and salary increases were attributable to anything other than the performance that was expected of the employee under the initial employment agreement.

Legitimate Interests of the Employer

A covenant not to compete will not be enforced unless the employer has some legitimate business interest that needs protection. Analysis of the legitimate interests of the employer usually falls into three areas:

- The relationship between the employee and the employer's customers;
- Confidential information in the possession of or known to the employee;
- Specialized training obtained by employee from employer.

Each is reviewed below.

The Relationship Between The Employee And The Employer's Customers. It is unfair for an employee to form a close association with an employer's customer in the course of his employment and then to leave the employer and take the customer with him. The employer clearly has an interest in restraining an employee from developing such a relationship on the employer's dime and then taking the customer after leaving the employer. In Minnesota caselaw, this is called having a hold on the goodwill of the employer.[8] Minnesota law encourages courts to enjoin the employee's contact with or solicitation of a customer for a period long enough to break the connection between the customer and employee. This allows the employer time to hire a replacement and develop a new connection between the customer and the replacement.[9]

Some decisions speak of barring the departing employee from competing for a length of time "necessary to obliterate the identification between employer and employee in the minds of employer's customers."[10] Using this formulation, courts have found it significant that customers were notified of the break between the employer and employee. However, this test ignores the fact that a relationship between a customer and employee may be such that the customer doesn't care who the employer is so long as the customer can work with the employee. In this circumstance, notifying the customer of a break between the employer and employee will only alert the customer that its business will be with a new employer. A more typical rationale, therefore, is to protect an employer against an employee capitalizing on the relationship he established with the customer at the employer's expense.

Of course, if the employer's business is not built around customer relationships, a covenant will not be enforced based upon the relationship between the customer and the employee. In one such case, *Rosewood Mortgage*, the court did not uphold the covenant because pricing rather than personal contacts predominated in the market and prices were set by large institutions.[11] Neither the employee's relationship with customers nor her knowledge of the employer's pricing, strategies, margins, etc. provided her an unfair competitive advantage.

Confidential Information. This article will not address in detail the elements of proof required to make a claim under the Minnesota Trade Secrets Act, Minn. Stat. §325C.01, et. seq. However, there is almost always a claim made under the Act in any non-compete case. Minnesota courts have held that confidential business information that does not rise to the level of a trade secret can nonetheless be protected by a properly drawn covenant not to compete.[12] The court in *Kirkevold* stated:

> To require an employer to prove the existence of trade secrets prior to enforcement of a covenant not to compete may defeat the only purpose for which the covenant exists. An employer need only show that an employee had access to confidential information and a court will then determine the overall reasonableness of the covenant in light of the interests sought to be protected.[13]

The court should still loosely apply the Act's analysis of whether the employer (or particular circumstances) made it clear to employees that specific information is confidential, and should make sure that the information is not accessible to anyone other than those who need the information.[14]

Even though confidential information need not rise to the level of a trade secret, courts will, nonetheless, very carefully scrutinize a claim that a non-compete should be enforced based on the threat that confidential information may be disclosed or used unfairly. The confidential nature of information and the need for protection is more obvious when a product incorporates cutting edge technology or the employee has unique technical knowledge or skill.[15] The employer's interest is less clear when a business sells basic widgets.

Examples. Most cases in which confidential information is the basis of the employer's efforts to enforce a non-compete agreement involve a claim that the former employee took the customer list when he left his employment. Customer lists are the life blood of many companies. Even if a former employee could obtain customer names from an independent source, that may not mean that the information is generally known or readily ascertainable. Consider an employee with access to a list of 10,000 names but who uses the employer's customer list instead. The customer list could be the result of years of effort by the employer through cold calls, extensive mass mailings, constant contact and so forth; the result of substantial effort by the employer to pare down the 10,000 names to a meaningful list of serious customers and prospects.[16] For the employee to take such a list would provide her with a huge advantage in competing with the employer. On the other hand, there are businesses in which the customers' names are so obvious that virtually anyone could find them (e.g., in the yellow pages or through lists published by various trade associations).

Sales projections, sales figures, margin figures, pricing, bids, estimates and marketing strategies have also been held to be confidential information.[17] The determination may depend upon whether the case involves a low-level employee or an executive.[18]

Although a court might enjoin an employee's use of confidential information, either under the Act or a confidentiality clause, it does not necessarily follow that the court will enjoin the employee's employment by a competitor altogether. A mixed result of this kind is not uncommon at the TRO, temporary injunction, or permanent injunction stages, depending upon the particular facts. The court will review the nature of the information or employment to determine if the employee can continue to work and compete in the particular field under limitations that will not compromise the former employer's interests.

Specialized Training. Note that it is *specialized* training, not just training, that will afford the employer protection.[19] Most employment requires training of some sort. The court may be expected to scrutinize carefully claims that the employer provided specialized training. While all products and services will require some training, the nature of the product may be such that training unique to that product is required. The amount of time and financial investment required to train the employee can provide some measure of whether it is specialized.

Conversely, if the employee can establish that she received specialized training during previous employment, the employer is not entitled to protection. Minnesota caselaw protects only the time, effort and expense actually invested by the plaintiff employer in the employee.[20]

In most cases, the employer will claim some combination of relationships between the employee and the customer, use of confidential information, and specialized training. Many judges have a good sense of what legitimate interests of the employer need to be protected. However, a judge's ability to craft a narrow TRO or injunction is generally defined by the quality or quantity of information provided by counsel.

"To deny temporary injunctive relief until the employer can prove an actual loss of customers defeats the very purpose of a covenant not to compete."

Duration of Non-Compete Period

In considering this issue the court will determine how long it will take for the employee's relationship with the customer to grow cold, for the confidential information to go stale, or for the replacement employee to be trained. As with other areas of consideration, there is no hard and fast rule that controls the length of the period of non-competition. A good general rule of thumb is one year from the date of separation, though the duration could be as short as six months or as long as two or three years. In the context of the sale of a business in which the seller is paid a portion of the purchase price in installments over the course of the period of non-competition, the duration could be five or ten years, or even longer.[21]

In some cases it may be appropriate to tack onto the contract period the period of time that the employee has been competing up to the time of the TRO or injunction. For example, if the covenant says one year from the date of termination but the employer doesn't discover for two months that the employee started competing immediately after termination, the employer will want an extra two months added to the length of the injunction. There is support for this in Minnesota caselaw.[22]

Geographic limitation

A geographic limitation on the employee's ability to compete is not required in a non-competition agreement if the restrictive covenant is otherwise reasonably tied to the protection of the employer's customers.[23] If the enforcement action is based upon confidential information, a geographic limitation may or may not be appropriate depending upon whether the information would be relevant outside the employer's market. If the enforcement action is based upon specialized training, protection is only needed within the geographic area covered by the employer's business.

A geographic limitation must be limited to only that territory in which the employer does business. The planet Earth can be a reasonable geographic limitation, but not if the employer confines its business to Ely, Minnesota. The limitation may be stated in terms of countries, states, counties, cities or a certain mile radius from a fixed point.

Irreparable Harm

At the TRO and temporary injunction stages the court must make a finding that the employer will be irreparably harmed if the non-compete is not enforced in order to grant injunctive relief. In *Thermorama, Inc. v. Buckwold*,[24] the court held that irreparable harm may be inferred from the breach of a covenant not to compete:

> The evidence of irreparable harm is not strong but there is inherent in a situation of this kind damage which is not susceptible of precise proof. If defendant has not breached the terms of his agreement, he suffers little detriment by the issuance of the injunction. On the other hand, if he is in violation, plaintiff may well lose a number of customers for whom it has not had a fair opportunity to compete, and may forfeit as well future benefits which are difficult to evaluate. Under these circumstances we think some irreparable harm may be inferred.

An apparent inconsistency has arisen between cases that infer irreparable harm and those that undertake a balancing of the harm (discussed below) as between the former employer and the employee.

In *Satellite*, for example, the employee formed a competing business and solicited the former employer's customers, so there was no issue about whether the non-compete was breached. Despite a clear-cut breach, the court ruled that because the competing business was not yet operating as of the time of hearing, the claim of irreparable harm was only speculative. In *Edin v. Jostens, Inc.*, the court said that the balance of the harm was the most important factor and refused to enforce the covenant because the employee was fifty years old, suffered from a diabetic condition, was unfairly terminated from employment and had exhausted 39% of his assets since termination.[25]

On the other hand, the court in *R.L. Youngdahl v. Peterson* found irreparable harm had been established through the former employee's solicitation of customers and signing of only one customer.[26] In *Webb v. Fosshage*, the court granted injunctive relief even though the employee had taken customers from only a small arm of the former employer's business which produced only a small percentage of the employer's total revenue. The employee alleged that he would have to file bankruptcy if he could not continue, but the court found that allegation to be conclusory, and the court emphasized his failure to show why he would be unable to transfer his experience to soliciting someone other than the former employer's customers.

In the author's opinion and experience, the analysis depends in part upon the stage of proceedings. At the TRO stage, it is usually very difficult to prove that the employee has taken any customers and, in fact, the employee may not have actually taken a customer since the TRO hearing is often within days or a couple of weeks of the last day of employment. It is generally not realistic to expect the former employer to prove the loss of a customer, or even direct solicitation of a customer by the employee, at the TRO stage. Just in terms of establishing irreparable harm, it should usually be enough if the former employer can establish that the employee has gone to work for a competitor or has formed a competing business.

This recognizes a number of practical realities. Employers often don't lose customers the day the employee walks out the door. Further, once a customer is gone, it is difficult to get a customer back. To force an employer to wait until customers leave would ignore the lag time between when the employee leaves and when the customer leaves and would only provide relief after it's too late. A TRO or temporary injunction recognizes the uniqueness of customer relationships, the time and effort it takes to attract and maintain customers, and the unfairness of allowing an employee who has developed customer relationships while in the employ of the former employer to take those customers. To deny temporary injunctive relief until the employer can prove an actual loss of customers defeats the very purpose of a covenant not to compete.

Even at the temporary injunction stage it may be too early to establish that customers have been lost. Employers are always loathe to contact their customers and ask if they have been solicited or whether they will testify at the temporary injunction hearing. Limited discovery often occurs prior to the temporary injunction so that the employee's activities can be explored.

The employee may rebut the inference of irreparable harm if he can adequately establish that he did not come into contact with former employer's customers in a way which gave him a "personal hold" on the goodwill of the business.[27] This would essentially amount to a showing by the employee that he did not have much or any contact with customers, that he is not now contacting the former employer's customers at all, or that the employer's customers are not attracted or held through relationships.

Finally, irreparable harm may be established through the actual or potential disclosure of confidential information or through a showing that the employee possesses such skill or training that she is a threat even in the absence of a strong relationship with customers. With respect to confidential information, the former employer is not expected to prove that the employee actually has documents in her possession; only that it is the type of information that would be valuable to a competitor and/or would provide the employee with an unfair competitive advantage. Conversely, the former employee is not expected to prove what she has retained in her head.

Balancing of the Harm and Likelihood of Success on the Merits

If irreparable harm is established, the court still balances the harm and considers the likelihood of success on the merits.[28] Most cases that find insufficient likelihood of success on the merits do so based on lack of consideration to support the non-compete.[29] Thus, in many cases, whether and what type of injunctive relief is granted comes down to the balancing of the harm. The balancing of the harm, as *Cherne* observed, provides the court with the opportunity to fashion an injunction so that it provides an adequate remedy to the employer without imposing unnecessary hardship on the employee. Usually, the court will try to find a way to allow the employee to continue working in her field of training, knowledge, or expertise while protecting the employer's customers and/or confidential information.

Courts can mitigate the harm to the employee through their broad power to "blue pencil" a covenant not to compete.[30] Blue penciling allows a court to effectively rewrite the covenant so that it protects as narrowly as possible the employer's legitimate business interests. This could take the form of shortening the duration or reducing the geographic scope of the covenant; identifying specific customers which the employee is enjoined from contacting or soliciting; and/or identifying specific documents or types of information which the employee is enjoined from using or disclosing. The court could even enjoin the employee from working on specific types of projects for specific customers or could establish a Chinese wall between the employee and certain of the new employer's departments or employees. If a TRO or temporary injunction is supported by the facts, the court has the ability to strike a balance between the employer's need for protection and the employee's need to earn a livelihood in the field in which he has experience.

Conclusion

Each case is decided on its own set of facts. For that reason, this article must speak largely in generalities for which there will almost always be exceptions. Should the author ever appear before a court and take a position which seems to contradict this article, rest assured that case is one of the exceptions.

"The planet Earth may be a reasonable geographic limitation, but not if the employer confines its business to Ely, Minnesota."

Notes

1 *Bennett v. Storz Broad. Co.,* 270 Minn. 525, 134 N.W.2d 892 (1965).

2 *Dahlberg Bros., Inc. v. Ford Motor Co*., 272 Minn. 264, 137 N.W.2d 314 (1965).

3 *Sanborn Mfg. Co. v. Currie*, 500 N.W.2d 161 (Minn. App. 1993); *Overholt Crop Ins. Serv. v. Bredeson*, 437 N.W.2d 698 (Minn. App. 1989); *Arnold Corp.-Printed Communication for Bus. Co. v. Anderson*, No. C2-89-1856, 1990 WL 28048 (Minn. App. March 20, 1990).

4 *Freeman v. Duluth Clinic, Ltd.*, 334 N.W.2d 626 (Minn. 1983).

5 See *Sanborn Mfg. and Arnold Corp.-Printed Communication for Bus. Co.*

6 *Davies & Davies Agency, Inc. v. Davies*, 298 N.W.2d 127 (Minn. 1980).

7 *Satellite Indus., Inc. v. Keeling*, 396 N.W.2d 635 (Minn. App. 1986).

8 *Millard v. Elec. Cable Specialists*, 790 F.Supp. 857

(D.Minn. 1992); *Webb Publ'g Co. v. Fosshage*, 426 N.W.2d 445 (Minn. App. 1988).

9 *Overholt Crop Ins. Serv. v. Bredeson*, 437 N.W.2d 698 (Minn. App. 1989); *Dean Van Horn Consulting Assoc., Inc. v. Wold*, 395 N.W.2d 405 (Minn. App. 1986).

10 *Dean Van Horn Consulting Assoc., Inc.; Ecolab v. Ford, No.* C4-94-2179, 1994 WL 510121 (Minn. App. April 25, 1995).

11 *Rosewood Mortgage Corp. v. Hefty*, 383 N.W.2d 456 (Minn. App. 1986).

12 See cases cited in *Modern Controls, Inc. v. Andreadakis*, 578 F.2d 1264 (8th Cir. 1978).

13 *Minn. Mining & Mfg. Co. v. Kirkevold*, 87 F.R.D. 324 (D.Minn. 1980).

14 Minn. Stat. § 325C.01, subd. 5.

15 See *Minn. Mining & Mfg.; Medtronic v. Sun, Nos.* C7-97-1185, C9-97-1186, 1997 WL 729168 (Minn. App. Nov. 25, 1997).

16 See *Cherne Indus., Inc. v. Grounds & Assoc., Inc*., 278 N.W.2d 81 (Minn. 1979). See also *Surgidev v. Eye Technology, Inc.*, 648 F.Supp. 661 (D.Minn. 1986); *Alside, Inc. v. Larson*, 300 Minn. 285, 220 N.W.2d 274 (1974).

17 *Kay-Sun Corp. v. Heller Inv., Nos.* C4-97-2052, C6-97-2053, 1998 WL 422182 (Minn. App. July 28, 1998); *D.L. Ricci Corp. v. Forsman, Nos.* C8-97-1597, C8-97-1969, 1998 WL 202595 (Minn. App. April 28, 1998).

18 *Compare Modern Controls, Inc.; Eutectic Welding Alloys Corp. v. West*, 281 Minn. 13, 160 N.W.2d 566 (1968).

19 See, e.g., *Eutectic Welding Alloys Corp.*

20 See, e.g., *W. Water Mgmt. v. Heine*, No. C4-95-2693, 1996 WL 35436 (Minn. App. April 30, 1996); *Jim W. Miller Constr., Inc. v. Schaefer*, 298 N.W.2d 455 (Minn. 1980).

21 See, e.g., *Bruner v. Klemp*, No. C1-95-2182, 1996 WL 208336 (Minn. App. April 30, 1996). But see, *Energy*

Solutions Int'l v. Tastad, No. C2-99-546, 1999 WL 787629 (Minn. App. Oct. 5, 1999).

22 *Cherne Indus., Inc.; Medtronic.*

23 *Dynamic Air, Inc. v. Bloch*, 502 N.W.2d 796 (Minn. App. 1993).

24 *Thermorama, Inc. v. Buckwold*, 267 Minn. 551, 125 N.W.2d 844 (1964).

25 *Edin v. Jostens, Inc.*, 343 N.W.2d 691 (Minn. App. 1984).

26 *RL. Youngdahl & Assoc., Inc. v. Peterson*, No. CO-87-2418, 1988 WL 35436 (Minn. App. April 19, 1988).

27 *BFI-Portable Serv., Inc. v. Kemple*, No. C5-89-1172, 1989 WL 138978 (Minn. App. Nov. 21, 1989).

28 *See*, n.3 above.

29 See, e.g., *Nat'l Recruiters, Inc. v. Cashman*, 323 N.W.2d 736 (Minn. 1982), *Sanborn Mfg*; *W. Water Mgmt*. For other reasons why no likelihood of success see, Jim W. Miller Constr.; *Eutectic Welding Alloys Corp.; Midwest Sys., Inc. v. Faulkner*, No. C9-97-2029, 1998 WL 252366 (Minn. App. May 19, 1998).

30 *Satellite; Dean Van Horn.*