Employment Law Alert: Non-Competition Laws

Important Reminder: Changes to MA Non-Competition Laws Starting October 1 – What To Do Now

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By now, many employers are aware that Massachusetts law governing non-competition agreements is changing at the end of this month. A non-competition covenant or agreement is a provision in either an employment agreement, offer letter or separate agreement where an employer provides to an employee or independent contractor payment or some other consideration (for example a stock option or bonus). The employee or independent contractor in turn agrees not to compete for a period of time, customarily one year, after leaving the employment relationship. To date, whether a non-competition agreement is enforceable has been largely a matter of judicial discretion and we invariably looked to case law for guidance.

Now, after a decade plus of the Legislature considering the topic, we have a new Massachusetts law effective October 1, 2018, Mass. Gen. L. c. 149, §24L (the "Act"), setting forth a number of rules governing non-competition covenants. As is the case with much legislation, the Act is a compromise among various constituencies. As such, it contains its share of ambiguities and competing interests that the courts will need to clarify over time. Nonetheless, it provides clarity in some areas. Here is a GPS to assist in the navigation of this new "non-compete" thicket and the heavily trafficked highway which will likely follow.

Do We Really Need A Non-Competition Agreement?

If your company tends to utilize non-competition agreements with little analysis as to whether they are truly needed, you are not alone. Now is an opportune time to reconsider. The Act imposes new rules as well as risks, described below, and employers will want to determine whether the value of a non-competition covenant is worth these risks and rules. It may be that a non-competition covenant is needed for certain positions but not others: for example, for senior executive officers, but not for employees below the director level. The Act specifically excludes nonexempt employees, employees under 18, and undergraduate or graduate students employed as interns from its coverage, so these employees are not included in this analysis. (*But this exclusion reiterates the importance of properly classifying employees as exempt or nonexempt.*)

General Requirements Have Not Changed.

As a preliminary matter, and as has been the consistent case in the past, the Act provides that to be enforceable, a non-competition covenant must adhere to three elements: (1) *no broader than necessary* to adequately protect legitimate business interests (the employer's trade secrets, confidential information and goodwill); (2) *reasonable in geographic scope* in relation to the interests protected; and (3) *reasonable in the scope of prohibited activities* in relation to the interests the employer seeks to protect. If a non-competition covenant is contested, judges will continue to determine whether these requirements have been satisfied. If the three elements have not been satisfied, judges have the discretion to modify and to reform the agreement as necessary. In addition, the Act does not apply in the event of the sale or other acquisition of a business. Hence, these court-tested and abiding principles and concepts are nothing new.

Clarification Under the Act.

The Act provides guidelines regarding what is "reasonable" in terms of scope of geographic restrictions and prohibited activities. Geographic scope is "*presumptively reasonable*" if "*limited to only the geographic areas in which the employee, during any time within the last two years of employment, provided services or had a material presence or influence.*" The scope of prohibited activities "*is presumptively reasonable*" if "*limited to only the specific types of services provided by the employee at any time during the last two years of employment.*" When drafting non-competition agreements, apply these presumptively reasonable standards, as we should anticipate that judges will be using these standards when considering enforceability.

The Act provides one bright-line rule to further consider: *the restricted period of post-termination non-competition cannot exceed 12 months*. This duration has become somewhat well-settled under case law and is not seen as controversial. We now have guidance on what happens if an employee "breache[s] his or her fiduciary duty" to the company or "has unlawfully taken, physically or electronically, property belonging to" the employer. Per the Act, under either of these circumstances, the restricted period extends to 24 months and the company will be relieved of any of its obligations under the non-competition covenant.

Other Restrictive Covenants Still Available.

The Act applies only to non-competition covenants. It expressly excludes: (i) non-solicitation covenants where the departing employee agrees that he or she will not solicit or hire the company's employees (or consultants or advisers) and will not solicit or transact business with the company's customers, strategic partners, clients, suppliers or vendors; (ii) nondisclosure or confidentiality agreements; and (iii) invention or assignment of intellectual property agreements. Consequently, employers should closely examine whether these covenants together sufficiently protect the company; a judge will undertake the same analysis and if the answer is yes, will not see the need for the non-competition covenant.

"Springing" Non-Competition Covenants.

To give further teeth to a non-solicitation, assignment of inventions and/or nondisclosure agreement, consider including a "springing non-competition" provision. In this provision, an employee expressly agrees and acknowledges that, in the case of a breach or threatened breach of a non-solicitation and/or nondisclosure agreement, fiduciary duties or other common law duties to the employer, the employer may seek, and a court may grant, a post-employment non-competition restriction as a remedy. Hence, a non-competition covenant "*springs*" into existence as a result of a breach of a non-solicitation, assignment of inventions and/or nondisclosure covenant. Bear in mind that the company still must convince a judge of the underlying breach, and, as such, this remedy of a springing non-competition covenant is not guaranteed.

Non-Competition Covenant Is Not Enforceable: Laid Off or Terminated Without Cause.

There is one potentially surprising aspect to the Act: where an employee is "laid off" or his or her employment terminates "without cause," a non-competition covenant – even the most beautifully-compliant, perfectly-drafted, fully-defensible one – will be unenforceable. Practically speaking, this consequence could actually be a positive development if the employer is not concerned with the departing employee competing, as the employer will not need to pay a termination stipend to support the employer's end of the bargain. However, if the employer does not want the employee competing, then this outcome is highly undesirable. Unfortunately, the Act does not define "without cause." As a result, employers now have one more thing to define (and to negotiate) in their non-competition covenants – and, potentially, one more thing to prove (or to disprove) in litigation over the enforceability of the non-competition covenant.

Severance Option.

Even if the non-competition covenant is unenforceable (or where there is not one in place), the company will have another opportunity to seek one. The Act expressly excludes non-competition covenants that are part of an employee's separation from employment – *provided*,

however, that in the written document, *"the employee is expressly given seven (7) business days to rescind acceptance."* Recall that the non-competition covenant must still meet the three overarching principles described above. It is also prudent to draft the "presumptively reasonable" standards regarding scope (geographic and restricted activities) into the non-competition covenant, as well as the twelve-month maximum duration and the twenty-four-month extension.

Yes, We Need A Non-Competition Covenant: What To Decide Next.

When a non-competition covenant is deemed necessary to adequately protect the company, the company needs to determine what type of consideration to provide to support the enforceability of the covenant. This depends initially on whether the company seeks the non-competition covenant before or after the commencement of employment.

Seeking When Hiring/Commencing Employment: Garden Leave or "OMAUC."

If the non-competition covenant is entered into in connection with the commencement of employment, employers have two choices for consideration: (1) pay "*Garden Leave*" or (2) provide "*other mutually-agreed upon consideration*" ("OMAUC"). "Garden Leave" is "*at least 50% of the employee's highest annualized base salary paid by the employer within the two years preceding the employee's termination.*" The Garden Leave must be in the form of payment and it must be made when the restricted non-competition covenant period starts, i.e., when employment ends. One benefit to Garden Leave is that it is clearly defined, leaving little opportunity for an employee to contest whether it is sufficient. In addition, while an employer cannot on its own stop making Garden Leave payments, the employer can waive the agreement. Given that non-competition covenants are unenforceable where an employee is laid off or employment terminates without cause, the employer ends up being able to waive the requirement in the case where an employee voluntarily leaves or is fired for cause. One drawback of Garden Leave is the amount. The "*50%-of-base pay*" amount strikes many employers as rather high, especially with higher-level employees having higher base salaries. *Further, the employer cannot use other forms of consideration, such as stock options or equity, to satisfy consideration obligations before employment ends.*

If seeking a more flexible form of consideration, consider going the OMAUC route. With OMAUC, the company and the employee agree to what consideration will be sufficient in exchange for the non-competition covenant and can earmark a portion of the employee's total compensation package as that consideration. For example, stock options or equity that is part of the total compensation package can be identified as the OMAUC. Under this scenario, the consideration is not an additional obligation to the employee on top of the employee's total compensation payable when employment ends, as is the case with Garden Leave. The Act doesn't define OMAUC or give illustrative scenarios. However, it is expected that OMAUC will pass judicial scrutiny provided that it is more than nominal, clearly agreed-upon in writing, and that there is no indication of coercion. It is anticipated that many employers will choose OMAUC over Garden Leave due to the flexibility of OMAUC. However, the choice of Garden Leave or OMAUC needs to be determined on a case-by-case basis.

Seeking a Non-competition Covenant After Commencement Of or During Employment: "Fair and Reasonable."

If the employer is seeking a non-competition covenant after the employee started working, a different standard as to what constitutes consideration applies. Under the Act, the employer must provide "*fair and reasonable consideration.*" While it is expressly clear that continued employment is no longer sufficient consideration to support a non-competition covenant, i.e., it is not "fair and reasonable" consideration, the Act does not define, or provide examples of, what is "*fair and reasonable consideration.*" This is one area of the new law that will be developed further through case law.

Procedural Requirements: Be Aware and Plan Ahead.

Be aware of the complex and tricky procedural requirements when seeking a non-competition covenant in connection with the commencement of employment or after. In both cases, the non-competition covenant must be in writing, signed by the employer and employee. The non-competition covenant must expressly state *that the employee has the right to consult with counsel prior to signing*.

When offered in connection with the commencement of employment, notice of the non-competition covenant must be provided to the employee "by the earlier of a formal offer of employment or 10 business days before the commencement of the employee's employment." The Act does not define "*formal offer of employment*" but it is reasonable to conclude that a written communication setting forth the offer and its terms, and seeking signed acceptance, is acceptable as the formal offer of employment. If the non-competition covenant is offered *after* the employee has commenced working, then the notice "*must be provided at least 10 business days before the agreement is to be effective.*" As a result, employers must be extremely careful to satisfy these procedural requirements in order to support the enforceability of a non-competition covenant.

Playing "Dodge Law" Prohibited.

In appropriate circumstances, employers can provide in employment-related agreements that other states' laws which are more favorable to the employer will apply. However, the Act prevents employers from exercising this option regarding non-competition covenants or agreements. The Act provides that if the employee resides or works in Massachusetts when employment terminates or at least 30 days before employment, the Act, i.e., Massachusetts law, applies. Implications are that the Act will now apply to non-Massachusetts employers, so that even if the employer's offices or facilities are outside of the state, employers cannot necessarily escape from the long reach of the Act.

Action Items.

At the end of the day, much of what the new Act provides for non-competition covenants is not necessarily novel in design or seismic in scope. Consequently, it still remains good law that to be enforceable, a non-competition covenant must be no broader than necessary to protect the company's legitimate business interests, and must also be reasonable in scope and duration. Employers are advised to harness the new Act as an opportunity to ensure that they are utilizing non-competition covenants as truly needed, thereby avoiding the cost and distraction of having to defend these covenants when they are not justifiable. Bear in mind the number of restrictive covenants already available that protect legitimate needs (e.g., non-solicitation and nondisclosure covenants), and that by including a springing non-competition covenant, employers can create a potential remedy of a court-ordered non-competition covenant. *Be especially aware of procedural requirements on notice and plan ahead as to not be caught off guard*.

Do not forget, in the midst of all of this analysis, the importance of company culture and the impact of unnecessary non-competition covenants on that environment. Consider how seeking non-competition covenant for new hires may impact company recruiting as the company competes in a hot talent market. These cultural considerations may well be the tipping point in a close decision.

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