Critique of House Bill, "An Act relative to Non-Compete Agreements" filed on January 20, 2011. Sponsors: Hon. William Brownsberger, Alice Peisch, and Lori Ehrlich

Background:

Businesses with 19 or fewer employees constitute 86% of all Massachusetts businesses (Source: Mass Housing and Economic Development statistics 2010).

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Smaller companies tend to be more susceptible to employee theft because of the informality in which they operate and lack of funds available for precautionary measures.

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Start-ups tend to minimize salaries by offering equity. Thus, salaries tend to be lower in start-up enterprises, often lower than the statewide household median of $60,000 per annum. (Source: MA Dept of Revenue & IRS)

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The statewide unemployment rate in California as of June 2010 was 12.3% and in Silicon Valley 11.8%, much worse than national average of 9.7%. Non-competes are prohibited in CA. In Massachusetts – where non-competes are routinely enforced – the unemployment rate for the same time period was 9.1% statewide. In the Research Triangle (North Carolina) the unemployment rate was 8.0% for the same time period. North Carolina enforces non-competes. (Source: U.S. Bureau of Labor Statistics)

These figures undermine the notion that outlawing non-competes helps create jobs by allowing greater employee mobility.

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Massachusetts courts already possess equitable powers sufficient to protect all interests in a non-compete battle.

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With the great advancements in technology, it is easier than ever today to walk off with hundreds or even thousands of pages of a company's documents containing trade secrets and confidential information in the breast pocket of one's shirt!

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Massachusetts already possesses a negative business climate perception because of such laws as mandatory healthcare, elimination of independent contractor status and the like.

Major Changes in the new Bill from the Previous Version

- The $75,000 salary threshold has been eliminated.
- Garden Leave provision has been reinserted
- The 10% payment as consideration for non-compete for already employed persons has been eliminated

- Added requirement that court must consider the economic circumstances of employee and economic affect enforcement of on-compete would have on the employee.

Objections to Specific Sections of the January 20, 2011, Bill:

Section (1) – "Garden Leave"

The amount is too rich for most companies to pay which effectively puts this provision beyond practical consideration

Section (b)(iv) – "Goodwill"

Recent case law in Massachusetts has clouded the issue of whether goodwill belongs to the employer or the employee. This is especially true in the sales area where non-compete agreements are routinely used in order to prevent salespeople from taking their employer's customers.

Section (b)(v) – Duration of Restriction

A one-year maximum with a six-month presumption of validity may be fine in the context of a hair salon, but is not so given Massachusetts "high-tech" business climate. The current law is that "a plaintiff is entitled to have its trade secrets protected at least until others in the trade are likely, through legitimate business procedures, to have become aware of these secrets."

In the case from which this quote is taken, a company developed a data acquisition module over 18 months at a cost of over $100,000. Two employees involved in developing the product resigned and took trade secrets, etc. They developed a competing product in a few months at a cost of $2,500, and proceeded to undersell their former employer.

The new bill ignores the realities of the "head start rule," and the time required to develop technically complex products.

Section (b)(vii) – "Limited to Specific Types of Services Provided by Employee"

In a famous Massachusetts case involving the theft of a secret cookie recipe, the company janitor stole the recipe from the owner's office and started a competing business. This restriction is too narrow, and does not take into account employment reality, and the ease with which employees can access company information which may not apply to their specific jobs.

Section (d) - Power to Abrogate Agreement in its Entirety

This section would allow courts to decline to enforce a private non-compete agreement on extremely nebulous grounds. It does not define what the "equitable factors" are, and thereby undermines the legitimate contractual expectations of the private parties. Moreover, the new bill has added a requirement that the court shall consider the "economic circumstances of, and impact upon, the restricted party."

This new section essentially allows a court to do away the contractual rights of private parties, and will make it harder for larger companies to enforce their non-compete agreements. Enforcing courts sit in equity on these matters and this provision essentially allows the court to refuse to enforce the non-compete.

This provision also gives the employee an argument which the court must consider, i.e, the classic David v. Goliath economic situation.

Section (e) - Mandatory Attorneys Fees Award to Employee

Many companies that take legal action against dishonest employees often struggle to find the resources to pay their own attorneys, much less the attorneys representing the employee as well. The language of this provision also creates an anomalous result. An employer could win the case at the injunction level, and still have to pay the attorneys fees of the employee.

For example, under the present formulation if a court decides to enforce the agreement but lower the restrictive non-compete period from 12 months to eight months, the employer has won the case, but still has to pay the employee's fees. This is true also if the geographic restriction is cut back by the court, but not limited solely to the employee's former geographic work area. In Massachusetts, it is not unusual for the reviewing courts to "blue pencil" these agreements. Thus, the skewed results are very likely to occur, and discourage enforcement of non-competes.

Section (e)(2) - Massachusetts already has a statue which allows the court to award attorneys fees against a party acting in bad faith (G.L. c. 231, s. 6F). Moreover, this section dealing with a declaratory judgment also may result in the same anomalous award of attorneys' fees *to the losing party.*

CONCLUSIONS

The purpose of non-competes is to reduce or eliminate the actual or possible appropriation of a company's trade secrets and other confidential business information. By allowing a complete yet time-limited ban on competition by former employees, non-competes work more effectively than non-disclosure and non-solicitation agreements in ensuring that proprietary information remains so.

The law in its current formulation will tend to discourage employers from seeking enforcement of non-competition agreement, or from entering into them in the first place. The statute sets up inherent barriers to enforcement such as mandatory awards of attorneys fees even in the case where the employer prevails.

Many company owners are forced to put all their assets – personal and otherwise - on the line to obtain adequate funding for their ventures. They should be allowed some measure of assurance that the fruits of their labors enjoy adequate legal protection.

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HOUSE . . . . . No. xxxxx

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The Commonwealth of Massachusetts

In the Year Two Thousand Eleven

An Act relative to noncompetition agreements.

Be it enacted by the Senate and House of Representatives in General Court assembled, and by the authority of the same, as follows:

SECTION 1. Chapter 149 of the General Laws, as appearing in the 2006 Official Edition is hereby amended by inserting after section 24K the following section:-

Section 24L. (a) As used in this section, the following words shall have the following meanings:

"Employee": an individual who is considered an employee under General Laws, chapter 149, section 148B.

"Employee noncompetition agreement": an agreement between an employer and employee, or otherwise arising out of an actual or expected employment relationship, under which the employee or expected employee agrees to any extent that he or she will not engage in activities

directly or indirectly competitive with his or her employer after the employment relationship has been severed. Employee noncompetition agreements include forfeiture for competition agreements, but do not include (i) covenants not to solicit or hire employees of the employer; (ii) covenants not to solicit or transact business with customers of the employer; (iii) noncompetition agreements made in connection with the sale of a business or substantially all of the assets of a business, when the party restricted by the noncompetition agreement is an owner of the business who received consideration for the sale; (iv) noncompetition agreements outside of an employment relationship; (v) forfeiture agreements; or (iii) agreements by which an employee agrees to not reapply for employment to the same employer after termination of the employee.

"Forfeiture agreement": an agreement that imposes adverse financial consequences on a former employee as a result of the termination of an employment relationship, regardless of whether the employee engages in competitive activities following cessation of the employment relationship. Forfeiture agreements do not include forfeiture for competition agreements.

"Forfeiture for competition agreement": an agreement that imposes adverse financial consequences on a former employee as a result of the termination of an employment relationship if the employee engages in competitive activities.

"Garden leave clause": a type of employee noncompetition agreement by which an employer agrees to pay the employee during the restricted period. To constitute a garden leave clause within the meaning of this section, an employee noncompetition agreement must (a) have a restricted period of no more than two years from the date of cessation of employment; (b) for the full restricted period on a pro rated, per annum basis and without offset for any income the employee may receive from other unrestricted activities, the greater of: (i) fifty percent of the

employee's highest annualized base salary paid by the employer within the two years preceding the employee's termination or (ii) $35,000 (together with an additional $700 for each full year from the effective date of this section); (c) require either that the payments are to be made in a lump sum within ten business days following the cessation of the employee's employment or that the payments are to be made on a pro rata basis in equal bi-weekly, or more frequent, payments starting immediately after the cessation of the employee's employment; and (d) not permit an employer to unilaterally discontinue or otherwise fail or refuse to make the payments, even if the employer voluntarily shortens the restricted period.

"Inevitable disclosure doctrine": a doctrine by which, in the absence of an enforceable employee noncompetition agreement, a former employee may be prevented from working at a competitor based on the expectation that the employment would inevitably lead to the disclosure of a trade secret or confidential information of the employer.

"Restricted period": the period of time after employment during which an employee is restricted by an employee noncompetition agreement from engaging in activities competitive with his or her employer.

(b) To be valid and enforceable, an employee noncompetition agreement must meet the minimum requirements of subsections (i) through (iii) hereof and meet or be capable of being reformed to meet the minimum requirements in subsections (iv) through (viii) hereof.

(i) The agreement must be in writing and signed by both the employer and employee.

(ii) If the agreement is a condition of employment, the agreement together with an express statement that the agreement is a condition of employment must, to the extent reasonably feasible, be provided to the employee by the earlier of seven business days before the commencement of the employee's employment or when any written offer of employment is first sent to the employee, provided that if an offer of employment is first communicated orally, the employee also must either (A) simultaneously be informed that an employee noncompetition agreement will be a condition of employment or (B) receive the required written notification prior to tendering resignation from any then-current employment.

(iii) If the agreement is entered into after commencement of employment, it must be supported by fair and reasonable consideration in addition to the continuation of employment, and notice of the agreement must be provided at least two weeks before the agreement is to be effective.

(iv) The agreement must be necessary to protect one or more of the following legitimate business interests of the employer: (A) the employer's trade secrets, as that term in defined in section 30 of chapter 266, to which the employee had access while employed; (B) the employer's confidential information that otherwise would not qualify as a trade secret; and (C) the employer's goodwill.

(v) The agreement must be reasonable in duration in relation to the interests protected and the duration of actual employment, and, with the exception of a garden leave clause, in no event may the stated restricted period exceed one year from the date of cessation of employment. A stated restricted period of no more than six months is presumptively reasonable. An agreement may permit the restricted period to be tolled by a court if the employee's breach of the employee noncompetition agreement was neither known to nor reasonably discoverable by the employer. Such tolling period will not count for purposes of the temporal standards specified herein.

(vi) The agreement must be reasonable in geographic reach in relation to the interests protected. A geographic reach that is limited to only the geographic area in which the employee, during any time within the last two years of employment, provided services or had a material presence or influence is presumptively reasonable.

(vii) The agreement must be reasonable in the scope of proscribed activities in relation to the interests protected. A restriction on activities that protects a legitimate business interest and is limited to only the specific types of services provided by the employee at any time during the last two years of employment is presumptively reasonable.

(viii) The agreement must be consonant with public policy.

(c) Notwithstanding anything to the contrary in this section, a court may, in its discretion, reform an employee noncompetition agreement so as to render it valid and enforceable. If a court shortens the duration of a garden leave clause, the court may, in its discretion, impose a pro rata reduction on the duration or amount of the required payments.

(d) Notwithstanding anything to the contrary in this section, a court may decline to enforce some or all of the restrictions in an otherwise valid and enforceable employee noncompetition agreement (1) in extraordinary circumstances; (2) where otherwise necessary to prevent injustice or an unduly harsh result; or (3) based on any other common law or statutory legal or equitable defense or doctrine, or on other equitable factors that would militate against enforcement. In assessing whether to enforce some or all of the restrictions, the court shall take into account the economic circumstances of, and economic impact on, the restricted party.

(e) A court shall award the employee reasonable attorneys' fees and costs incurred in defending against the enforcement of any employee noncompetition agreement (1) if the court declines to enforce a material restriction or reforms a restriction in a substantial respect, unless (i) the specific rejected or reformed restriction is presumptively reasonable as set forth above; (ii) the employer made objectively reasonable efforts to draft the rejected or reformed restriction so that it would be presumptively reasonable as set forth above; or (iii) the agreement is a garden leave clause; or (2) if the court finds the employer to have acted in bad faith in connection with the enforcement of the employee noncompetition agreement. The entitlement to legal fees shall also apply to an employee who commences a lawsuit challenging his or her employee noncompetition agreement, provided that at least two business days prior to the filing of such lawsuit, the employee provided the former employer with specific measures that the employee would take to protect the employer's legitimate business interests, which measures are

substantially adopted by a court as part of a hearing on preliminary injunctive relief. The entitlement to legal fees shall apply regardless of whether the employee pays the legal fees himself or herself or if the legal fees are paid by another person or entity. A court may award attorneys' fees and costs at any time during the proceedings, including as part of a decision in connection with a preliminary injunction motion. Any such award of fees and costs shall be immediately due and payable to the employee. A court may require the employer, at any point, to post a bond or multiple bonds to cover any anticipated fees and costs.

(f) A court may award the former employer some or all of its reasonable attorneys' fees and costs incurred in connection with the enforcement of the employee noncompetition agreement permitted by contract or statute only if (1) the employee noncompetition agreement was presumptively reasonable in duration, geographic reach, and scope of proscribed activities; (2) the employee noncompetition agreement was enforced by the court without substantial modification; and (3) the court finds that the employee engaged in bad faith conduct.

(g) The substantive, procedural, and remedial rights provided to the employee in this section are not subject to advance waiver.

(h) Except as expressly provided by this section, a person defending against or otherwise opposing the enforcement of an employee noncompetition agreement, including by way of challenging the waiver of a substantive, procedural, or remedial right provided in this section, shall not be subject to any contractual penalty, requirement to indemnify, tender back, or any other similar disadvantage imposed as a consequence of such defense or opposition, and shall continue to be entitled to the rest of the benefits flowing from the contract. Any contractual provision to the contrary is void.

(i) No choice of law provision that would have the effect of avoiding the requirements of this section will be enforceable if the employee is, and has been for at least thirty days, a resident of or employed in Massachusetts at the time of his or her termination of employment. This provision may not be avoided by an involuntary transfer of the employee out of Massachusetts.

(j) Forfeiture agreements otherwise permitted by law are enforceable only if and to the extent that: (1) they comply with subsections (b)(i) through (b)(iii) and (2) the forfeiture is directly and reasonably related to the harm caused to the employer by the employee's departure, provided that such harm threatens the continued viability of the employer. Subparagraph (2) of this paragraph j does not apply to incentive equity compensation plans or agreements. Any harm that may result from increased competition or the replacement of the employee is not considered harm for purposes of this subsection.

(k) This section may expand, but shall not narrow, the prohibitions imposed by: (1) sections 12X, 74D, 129B, or 135C of chapter 112; (2) section 186 of chapter 149; or (3) applicable industry or other regulation or rules.

(l) Nothing in this section shall expand or restrict the right of any person to protect trade secrets or other confidential information by injunction or any other lawful means under other applicable laws or agreements. Notwithstanding the forgoing, the inevitable disclosure doctrine is rejected and shall not be utilized, although an employee who has disclosed, threatens to disclose, or is likely to intentionally disclose trade secrets or other confidential information belonging to his or her prior employer may be enjoined in any respect that a court of competent jurisdiction deems appropriate.

(m) This section shall not apply to or alter existing law concerning: (1) any restrictive covenant other than employee noncompetition agreements and forfeiture agreements; or (2) the payment of wages.

SECTION 2. This act may be referred to as the Noncompetition Agreement Act and shall apply to employee noncompetition agreements entered into on or after January 1, 2012.