Shook, Hardy & Bacon L.L.P.

Protecting Business Assets:
Unfair Competition, Non-Competes & Trade Secrets

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SHB National Employment Litigation & Policy Group

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JEALOUSY & SECRETS: NON-COMPETES VS. NON-DISCLOSURE AGREEMENTS

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Introduction

Businesses face a constant battle to protect their confidential, proprietary and trade secret information. Disgruntled ex-employees, not business competitors, can be the most dangerous foes in this battle. There are a number of options for guarding corporate information from a jealous employee. In some instances, a "need to know" policy can be effective. Ultimately however, at least some employees must have access to the company's most sensitive information. Therefore, to shield these assets, companies have usually turned to non-compete agreements or non-disclosure agreements. An understanding of what each of these agreements entails and the pros and cons of using them is a helpful first step to protecting corporate secrets when corporate relationships go sour.

Understanding Non-Compete Agreements and Non-Disclosure Agreements

Non-Compete Agreements

A covenant not to compete, or non-compete agreement, is a contract between an employer and an employee that prohibits the employee from operating in the same field of business as the employer. These contracts require consideration. Therefore, they are normally entered into at the outset of employment. Thereafter, it may be difficult for an employer to add or vary the terms of the agreement. But some courts have found consideration in continued employment. To be enforceable, the prohibition must be limited in scope. Further, these agreements are disfavored by courts as a restraint on trade. And courts therefore require the employer to meet a very high burden of proof, including a showing of a legitimate business reason for the restriction. In addition, the level of protection available varies with the status of the employee and the level of the employer's investment in the employee. These agreements are often used by employers to protect confidential information divulged to the employee as part of their job, but may also protect an employer's investment in the employee in unique skills and training.

About SHB

Recognized by *Business Week* as "the law firm of choice for many companies plagued by high-stakes [litigation] woes," SHB is internationally known as the litigation firm to hire to defend complex commercial, antitrust, employment, environmental, ERISA, products liability, and mass tort litigation.

The SHB Employment Litigation & Policy Practice Group represents corporate employers exclusively. In *Chambers USA America's Leading Business Lawyers — A Clients' Guide,* the group is "lauded for both its class action work and its effective advice to employers on federal compliancy issues." The group represents a number of *Fortune* 500 companies throughout the United States.

The group is distinguished by a highly imaginative and innovative approach based on the wealth of the firm's litigation experience (class action issues, expert witness development, e-discovery, effective case-management technology, award-winning diversity efforts and professional development programs, a national local counsel network, and the best practices of convergence programs).

Non-Disclosure Agreements

On the other hand, a non-disclosure agreement protects confidential information. It is an agreement not to share particular information with others or use it for any purpose beyond the scope of the agreement. These agreements are also contracts, so they generally require consideration. But in this instance they may be entered into at the time the information is shared. As more confidential information is shared, the agreement can be augmented. Many companies have a security program that requires all employees to sign such agreements annually as a condition of continued employment. Further, non-disclosure agreements are not limited by the status of the parties and therefore can cover consultants, independent contractors or even other business entities such as customers, suppliers and joint venturers. The enforcement of a non-disclosure agreement is limited by the type of information it purports to protect. It is not possible to prevent disclosure of information that is already in the public domain. On the other side of the spectrum, trade secrets may be strictly protected.

The information to be protected should be identified with particularity in the contract and often includes customer lists, marketing or business plans and strategies, proprietary processes, technology, and business methods. These agreements are used both inside and outside the context of employment and can serve many of the same purposes of covenants not to compete. But they are not subject to the same level of scrutiny by courts.

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Pros and Cons of Non-Competes

The focus of a non-compete agreement is market competition and its main advantage is the ability to shut out potential competitors. If the employer successfully meets the high burden of proof, a court will award an injunction preventing the operation of the competing business. But this injunction will be limited to what is necessary to protect the former employer's business. And if a business seeks too large a restriction, it may be left with nothing.

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As a restraint on trade, covenants not to compete are highly disfavored by courts. Therefore their terms are strictly construed against the employer. Further, the employer generally bears a high burden of proof including showing that the prohibition is necessary for a legitimate business reason and that it is reasonable in scope. The greater the scope the employer asserts, the greater its burden will be before the court.

The geographic scope can be nationwide or even worldwide depending on the nature of the business and the level of the employee, but generally is limited to the particular markets where the employer operates. Along the same lines, an employer may not be able to prevent a former employee from operating in a market (either geographic or field of business) that the employer has not yet entered. Thus, the former employee may inhibit the employer's expansion.

The prohibition must also be limited in time, often ranging between one to five years. Again, the length of time that is reasonable will depend on the employer's business and the level of skill and knowledge of the employee. Most states have adopted statutes covering non-compete agreements, some of which

are particularized to specific professions. Some states have "no blue-lining" rules. In those states, if any part of a non-compete agreement is overbroad or otherwise unenforceable, courts will not amend ("blue line") the agreement so that it falls within the law. Rather, the entire contract will be tossed out.

Finally, companies seeking to enforce non-compete agreements must seek, but may have difficulty obtaining, injunctive relief. Generally, proof of an "irreparable injury" which cannot be compensated with money damages is a prerequisite to preliminary or permanent injunctive relief. If a court believes money damages will protect the owner of the secret information, it may decline to enter an injunction.

One of the main advantages of a non-compete over a non-disclosure agreement is the ability to protect employer investment in forms other than confidential information. For example, an employee who acquires a particular skill on the job through employer investment, even if this skill is publicly known, may be prohibited from using that skill in competition with the employer.

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Companies might consider non-compete agreements where there is a well-defined market; high employee mobility; and barriers to market entry, beyond the proprietary information, are otherwise low. In doing so, they must recognize that the agreement must be crafted to fall within the ambit of the law, and that enforcing the agreement against a jealous former employee may still be an uphill battle.

Pros and Cons of Non-Disclosure Agreements

Non-disclosure agreements do not face the same legal impediments to enforcement as non-competes. They are not disfavored, so they are enforced as other contracts. Further, they do not require an employment relationship so they can be effective before, during and after employment and they can protect information shared with consultants, independent contractors and other businesses.

The "doctrine of inevitable disclosure" supports confidentiality agreements in some states. This doctrine may be invoked when a court finds that the circumstances of an ex-employee's new employment will inevitably lead to the disclosure of the confidential information. Under those circumstances, the non-disclosure agreement may be invoked to preclude or limit the new employment. The effect can be similar to a non-compete, but without the problems outlined above. Use of the doctrine, where available, can be a potent tool for protecting sensitive competitive information.

The nature of the information protected is the main limitation of non-disclosure agreements. If the information is already publicly known or distributed to a large number of people, it will be very difficult to enforce the non-disclosure agreement. Conversely, trade secrets involving proprietary technology known only to a select group of people inside the business would be afforded great protection. Somewhere in the middle is confidential information that does not rise to the level of a trade secret. The more work the business invested in the development of the information, the more likely it is to be protected and the greater the scope of that protection.

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Organizations that may use non-disclosure agreements are those with highly confidential information. Employee mobility and barriers to competition may not be as important to these companies as those considering the use of non-compete agreements.

Conclusion

Whatever the nature of the business or competitive environment, early consideration of which of these approaches, among others, most meets the organization's needs is a wise investment. At the beginning of an employment or business partnership, everything may appear rosy. But these relationships can go sour, so these tools may shield your company when it is most vulnerable to attack from the jealous ex.

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