Business Use and Enforceability of Noncompete Agreements

by Matthew G. Dunning and Justin A. Sheldon

Introduction

Noncompete agreements can be useful contracts to protect a legitimate business interest, whether that is in the context of an employer/employee relationship or the sale of a business. Most states, including Nebraska, have at-will employment, which means employers can fire an employee at any time and an employee can leave employment at any time. However, in certain industries, employers may want to place restrictions on where and what an employee can do after leaving employment, whether they quit or are fired; within limitations, significant restrictions can be imposed by requiring an employee to execute a noncompete agreement as a term of employment. The same can be said when dealing with the disposition of a business; a purchaser has a legitimate business interest in wanting to restrict the seller from going out and opening a competing business after the sale.

However, the enforceability of noncompete agreements can be compromised if the document is not drafted properly. Both purchasers and employers need to ensure that the restrictions placed on a seller or an ex-employee protect a legitimate business interest. Nebraska courts take a limited view of what can be restricted, particularly in the context of employment relationships that have ended.

Overview of Noncompete Agreements

A. The Purpose of Noncompete Agreements

The Nebraska Supreme Court has repeatedly affirmed the following as it relates to noncompetition agreements, including both selling a business and ending an employment relationship:

> Whether a noncompete clause is valid and enforceable requires us to categorize the covenant as either an employment contract or the sale of goodwill. Regardless of the context, a partial restraint of trade such as a covenant not to compete must meet three general requirements to be valid. First, the restriction must be reasonable in the sense that it is not injurious to the public. Second, the restriction must be reasonable in the sense that it is no greater than reasonably necessary to protect the employer in some legitimate business interest. Third, the restriction must be reasonable in the sense that it is not unduly harsh and oppressive on the party against whom it is asserted.[1]

B. Law Governing Noncompete Agreements

In Nebraska, courts apply Nebraska law to the enforceability of noncompete agreements; to do otherwise has been deemed to be a violation of Nebraska public policy. However, if an employee who works in Nebraska is employed by a company outside Nebraska and has signed a noncompete agreeing to a different state's law, it may be that the employee will be subject to the enforceability standards of that other state. This has the potential to expose the employee to a temporary or permanent injunction that can be much broader and more expansive than if the agreement was reviewed under Nebraska law. An issue of particular concern would be whether the other state has the practice of modifying agreements to make them enforceable. Nebraska does not modify agreements; if there is a provision that is not enforceable, that provision will not be amended in order to correct the defect in drafting. In *Mertz v. Pharmacists Mutual Insurance Company*,[2] the Nebraska Supreme Court found that Nebraska's substantive law should apply. The result as a matter of Nebraska law was that the covenant not to

compete clause was overly broad and was therefore unenforceable.[3] This was the Court's finding even based on all of the relevant business being conducted in Nebraska (even though the former employee lived in Iowa when the contract was signed).

C. Distinction Between Employer/Employee Noncompete Agreements and Noncompete Agreements Related to a Sale of Business

Noncompete agreements in the context of an employment relation are actually limited to being a nonsolicitation agreement. Employers may restrict former employees from soliciting the company's customers if the agreement is carefully written. The basic standards are that the types of customers that can be restricted from solicitation by the former employee are only those customers with whom the employee had personal contact and did business. In *Professional Business Services v. Rosno*,[4] the Nebraska Supreme Court held that a noncompete agreement was overly broad where the agreement prohibited the former employee from soliciting or contacting any of the former employer's clients and where the former employer could not establish the former employee had done business with or had substantial personal contact with all of the former employer's clients.[5]

A general geographic restriction cannot be enforced because the territory restricted can very likely be shown to include customers with whom the former employee did not have personal contact and did not do business. This is a relatively narrow restriction compared to what other states will do. However, this can also be to an employee's disadvantage. If the employee has had the required personal contact and prior business relationship, the employee will be restricted from soliciting that customer regardless of where the customer is located.

The length of time a former employee can be restricted is relatively short. Provisions that are enforced are typically limited to two years, and many employers have provisions that restrict solicitation for a period of only one year. The intent of this policy of the courts is to allow a company to make efforts to again establish a direct relationship with the customer at issue, rather than allowing the former employee to maintain the relationship and take the customer away from the company.

In the context of the sale of a business, on the other hand, the intent is to allow the purchaser of an enterprise to maintain the existing business and not have the seller move across the street and compete for the same customers. As a result, noncompete agreements in the context of a sale of business are not limited to the nonsolicitation of customers but can be based on a reasonable geographic territory that is sufficient to protect the new owner's legitimate business interests.

Noncompete Agreements Under Fire

Noncompete agreements have been under fire from more than one front at the federal level.

On July 9, 2021, President Biden issued an "Executive Order on Promoting Competition in the American Economy." This order is aimed at promoting a "fair, open, and competitive marketplace" in the hopes of creating "more high-quality

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jobs and the economic freedom to switch jobs or negotiate a higher wage."[6] Among other things, but of most importance for noncompete agreements, President Biden has asked the Federal Trade Commission ("FTC") to exercise its statutory rulemaking authority "to curtail the unfair use of non-compete clauses and other clauses or agreements that may unfairly limit worker mobility."[7]

What action the FTC takes has yet to be seen. The mandate of the Executive Order is to ask the FTC to take a deeper look at noncompete agreements and issue rules in line with the Executive Order. It is unlikely, however, that the FTC comes out with a rule entirely banning noncompete agreements. Any attempt by the FTC to do so would almost certainly face challenges from a multitude of industries and business groups, whether in the form of litigation or policy influence from lobbyists. Instead, the Executive Order is likely limited to ending overbroad and overbearing noncompete agreements that fail to protect a legitimate business interest, as is already the law in Nebraska.

In addition to President Biden's Executive Order, earlier this year, the Workforce Mobility Act of 2021 ("WMA"), H.R. 1367, was been introduced in both houses of Congress. If enacted, WMA would prohibit noncompete agreements with two exceptions: (1) the sale of goodwill or ownership interest, or (2) the dissolution or disassociation of a partnership.[8] Even those exceptions to the general prohibition have additional limiting factors that must be considered, including geographical area and time constraints.

At present, it is unclear if WMA has the votes to pass in Congress. Previous bills that aimed to eliminate or severely restrict noncompete agreements have failed. However, it is worth noting that WMA has bipartisan support.

Whether WMA is enacted, or action is taken on the Executive Order, businesses need to review their current

employment agreements that contain noncompete provisions—or their stand-alone noncompete agreements—to make sure they are enforceable and compliant with current law in Nebraska. Businesses need to also consider evaluating and updating their policies and practices to protect their legitimate business interests to get ahead of and avoid running afoul of local law and the current Executive Order.

What Can Companies Do Outside of Noncompete Agreements?

An attempted prohibition on noncompete agreements in the context of a sale of business is likely to be rejected or be very limited in scope. To expect a person to purchase an enterprise only to have the seller be able to take the business sale proceeds and immediately engage in the same enterprise is nonsensical and would be subject to challenge. As a result, it is very likely that companies will still be able to use noncompete agreements much in the same way prior to potential federal action on the issue.

In the context of an employment relationship, an employer can restrict a former employee's use of confidential information, including trade secrets:

> (4) Trade secret shall mean information, including, but not limited to, a drawing, formula, pattern, compilation, program, device, method, technique, code, or process that:
>
> (a) Derives independent economic value, actual or potential, from not being known to, and not being ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use; and
>
> (b) Is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.[9]

In addition, an employment agreement can be broader and include confidential information that is not necessarily protected as a trade secret.

Conclusion

Though noncompete agreements can be a valuable tool, the rules governing noncompete agreements must be strictly observed to avoid the risk that the noncompete is unenforceable as a matter of law.

Endnotes

1 *Unlimited Opportunity, Inc. v. Waadah*, 861 N.W.2d 437, 442-43 (Neb. 2015).

2 261 Neb. 704 (Neb. 2001).

3 *Id.* at 707.

4 268 Neb 99 (Neb. 2004).

5 *Id.* at 107.

6 Exec. Order No. 14036, 36 FR 36987 (July 9, 2021).

7 *Id.*

8 Workforce Mobility Act of 2021, H.R. 1367, 117th Cong. § 3 (2021).

9 Trade Secrets Act, Nebraska Revised Statutes § 87-501 et seq.

If you are aware of anyone within the Nebraska legal community (lawyers, law office personnel, judges, courthouse employees or law students) who suffers a sudden, catastrophic loss due to an unexpected event, illness or injury, the NSBA's SOLACE Program can likely assist that person in some meaningful way.

Contact Mike Kinney at mkinney@ctagd.com and/or Liz Neeley at lneeley@nebar.com for more information.

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