

**NON-COMPETE, NON-DISCLOSURE,  
AND NON-SOLICITATION CLAUSES  
IN EMPLOYMENT CONTRACTS**

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**September, 2000**

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## **NON-COMPETE, NON-DISCLOSURE, AND NON-SOLICITATION CLAUSES IN EMPLOYMENT CONTRACTS**

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In many of today's highly competitive industries, information and knowledge truly represent power in the marketplace. Of course, to unleash the power and profitability of the information, employers often must impart proprietary information and knowledge to their employees. In order to insulate proprietary information from business competitors, employers frequently attempt to protect their competitive business advantages by requiring their employees to sign employment contracts containing covenants not to compete, non-disclosure provisions, and non-solicitation provisions.

In general, a covenant not to compete may exist either as a separate contract or as a provision in a more comprehensive employment contract. Covenants not to compete typically seek to prohibit employees from working in related and competing businesses for a certain length of time after leaving their employer. Non-competition provisions may also seek to prevent past employees from using or disclosing the employer's confidential information, or from soliciting other employees who possess confidential knowledge to work at competing businesses. Courts have not looked favorably upon covenants not to compete because those provisions may severely restrict an individual's choices for alternate employment and ability to earn a living. In fact, Colorado law renders covenants not to compete void unless those provisions fit into one of the narrowly construed statutory exceptions.<sup>2</sup>

Over the last several years, the non-compete clause in employment contracts has emerged as a sensitive area triggering a large volume of litigation. For example, managed health care has forced physician groups to protect their alliances by adding non-compete clauses in physician

employment contracts. Thus, non-compete clauses can help medical groups “protect themselves generally against the threat of a physician employee departing with a host of patients that he or she acquired only through the group’s own visibility.”<sup>3</sup> Because Colorado courts and private arbitrators have often invalidated non-compete clauses, however, employers must draft those provisions narrowly in order to get voluntary compliance from past employees or effective enforcement from neutral fact-finders.

## **I. THE STATUTORY FRAMEWORK IN COLORADO**

In general, Colorado statutes provide that “[a]ny covenant not to compete which restricts the right of any person to receive compensation for performance of skilled or unskilled labor for any employer shall be void,” except in very limited circumstances.<sup>4</sup> Therefore, covenants not to compete in contracts controlling employment relationships are unenforceable except for:

- (a) Any contract for the purchase and sale of a business or the assets of a business;
- (b) Any contract for the protection of trade secrets;
- (c) Any contract provision providing for recovery of the expense of educating and training an employee who has served an employer for a period of less than two years;
- (d) Executive and management personnel and officers and employees who constitute professional staff to executive and management personnel.<sup>5</sup>

In 1982, the Colorado General Assembly amended the statute to include special provisions addressing covenants not to compete contained in physician service contracts.

Any covenant not to compete provision of an employment, partnership or corporate agreement between physicians which restricts the right of a physician to practice medicine, as defined in section 12-36-106, C.R.S., upon termination of such agreement, shall be void; except that all other provisions of such an agreement enforceable at law, including provisions which require the payment of damages in an amount that is reasonably related to the injury suffered by reason

of termination of the agreement, shall be enforceable. Provisions which require the payment of damages upon termination of the agreement may include, but not be limited to, damages related to competition.<sup>6</sup>

Therefore, the statute controlling non-compete provisions for physicians makes a clear distinction between prohibitions against competition and the recovery of damages arising from competition.

Prior to the statutory amendment in 1982, Colorado case authorities generally permitted courts to enforce non-compete provisions in physician employment contracts. In Boulder Medical Center v. Moore,<sup>7</sup> the Colorado Court of Appeals enforced a non-compete provision that prohibited a physician from practicing medicine in Boulder County for *five years* following his voluntary separation from employment. The court's opinion noted the existence of the then-new statutory provision prohibiting certain contractual restrictions on the right to practice medicine. The court, however, refused to apply the statutory prohibition retroactively to the physician and the contract in the case. The current statute, had it applied, would have rendered the five year practice restriction unenforceable. Yet, the holding may continue to have some vitality in situations that involve health care providers or employees other than physicians.

The statute applicable to physicians only renders covenants not to compete unenforceable when both of two circumstances exist. First, the covenant not to compete must be contained in an agreement "between physicians."<sup>8</sup> Second, the covenant not to compete must restrict the physician's right to "practice medicine."<sup>9</sup> The "practice of medicine" is defined under the Colorado Medical Practice Act.

(a) Holding out one's self to the public within this state as being able to diagnose, treat, prescribe for, palliate, or prevent any human disease, ailment, pain, injury, deformity, or physical or mental condition, whether by the use of drugs, surgery, manipulation, electricity, telemedicine, the interpretation of tests,

including primary diagnosis of pathology specimens, images, or photographs, or any physical, mechanical, or other means whatsoever;

(b) Suggesting, recommending, prescribing, or administering any form of treatment, operation, or healing for the intended palliation, relief, or cure of any physical or mental disease, ailment injury, condition or defect of any person with the intention of receiving therefor, either directly or indirectly, any fee, gift, or compensation whatsoever;

(c) The maintenance of an office or other place for the purpose of examining or treating persons afflicted with disease, injury, or defect of body or mind;

(d) Using the title M.D., D.O., physician, surgeon, or any word or abbreviation to indicate or induce others to believe that one is licensed to practice medicine in this state and engaged in the diagnosis or treatment of persons afflicted with disease, injury, or defect of body or mind, except as otherwise expressly permitted by the laws of this state enacted relating to the practice of any limited field of the healing arts.

(e) Performing any kind of surgical operation upon a human being; and

(f) The practice of midwifery, except [for services rendered by certain licensed and certified nurse-midwives or properly registered and practicing direct-entry midwife].<sup>10</sup>

Of course, a “physician” is a person who has a license to “practice medicine” under Colorado law.<sup>11</sup>

A non-compete clause in an agreement between physicians is not void and unenforceable simply because a party is a physician. Rather, the covenant not to compete in an agreement between physicians must also purport to restrict a physician’s right to practice medicine. Thus, a physician whose scope of employment does not include the practice of medicine will be subject to the more general provisions of Colorado’s non-compete statute.<sup>12</sup> For example, employers may contract with physicians to perform duties that do not involve the practice of medicine in a variety of contexts, such as the following:

- A medical director for a managed care organization;

- A medical school faculty member without attending responsibilities;
- A risk manager for a hospital or clinic;
- An investigator in a peer review matter; or
- A medical consultant in any capacity (such as a medical advisor for a news organization, an insurance company, a professional corporation of physicians, or a law firm).

The statute related to covenants not to compete between *physicians* does not apply to agreements involving non-physician medical professionals. The definition of the “practice of medicine” in the Colorado Medical Practice Act expressly excludes many other health care professions<sup>13</sup>, including:

- Dentists
- Podiatrists
- Optometrists
- Chiropractors
- Professional Nurses
- Certified Nurse-Midwives
- Acupuncturists
- Qualified Athletic Trainers

Thus, courts may enforce covenants not to compete in agreements involving non-physicians that fall under the more general provisions of the non-compete statute.<sup>14</sup>

Similarly, the statute controlling non-compete provisions for physicians applies only when a contract is an “agreement between physicians.”<sup>15</sup> The Colorado Medical Practice Act expressly permits “[p]ersons licensed to practice medicine” to “form professional service

corporations for the practice of medicine under the Colorado corporation code,”<sup>16</sup> and to employ physicians. Colorado law also permits hospitals to employ physicians.<sup>17</sup> Therefore, the statute controlling non-compete provisions for physicians may not apply when a hospital or hospital system directly employs a physician.

Although the covenant not to compete statute prohibits agreements that restrict a physician’s right to practice medicine, the statute expressly permits the recovery of damages in an amount reasonably related to the injury suffered due to the termination of the non-compete agreement. These damages may include damages related to competition.<sup>18</sup> Therefore, under the statute, a physician who breaches a non-compete clause cannot be restricted from practicing medicine, but may have to pay damages to the non-breaching party for the “privilege” of practicing medicine in violation of the non-compete clause.

The leading Colorado case interpreting the issue of damages in the context of physician non-compete clauses is Wojtowicz v. Greeley Anesthesia Services.<sup>19</sup> In that case, an anesthesiologist entered into a professional employment agreement that contained a contractual non-compete provision. The non-compete clause provided for the payment of *liquidated damages* to the professional corporation in the event the employment terminated and the anesthesiologist continued to practice within a 25-mile radius during the two-year period following the termination. The liquidated damages due under the contract included a payment of \$10,000 for loss of goodwill, forfeiture of the physician’s last three months salary, and a payment of 50% of the physician’s future fees generated from his competing practice during the two years following the termination.

The Colorado Court of Appeals held that the liquidated damages provision contained in the non-compete agreement violated the special statute relating to physician non-compete

agreements. The court noted that while the statute provides for the payment of damages related to competition, the amount of the liquidated damages must be “*reasonably related to the injury suffered*” by reason of termination of the agreement, and cannot be based on speculation or conjecture. The court found that the liquidated damages claimed by the professional corporation bore little relation to the actual damages incurred as a result of the physician’s competition. Thus, the court ruled that the liquidated damages provisions of the physician’s non-compete agreement were so disproportionate as to constitute an unenforceable penalty.

A professional corporation would ordinarily limit or mitigate its damages arising from a departing physician’s competition by attempting to prevent the patients of the departing physician from seeking services from the departing physician. On the other hand, the American Medical Association’s ethical opinions strongly protect the ongoing nature of the physician-patient relationship. The AMA’s ethical opinions recognize that a “patient has the right to continuity of health care” and that each “physician has an obligation to cooperate in the coordination of medically indicated care with other health care providers treating the patient.”<sup>20</sup> The AMA’s Council on Ethical and Judicial Affairs has stated that “[c]ovenants not to compete ... disrupt continuity of care, and potentially deprive the public of medical services.”<sup>21</sup> Similarly, the Colorado Board of Medical Examiners has historically required a professional corporation to notify patients of the whereabouts of departing physician or to allow the departing physician to notify patients of a competing practice. The Board of Medical Examiners has historically viewed the failure to give such notices as “abandoning patients” by the departing physician, or “interfering with physician-patient relationship” by the professional corporation.<sup>22</sup>

For employment contracts involving non-physicians, non-compete provisions will become void unless facts exist to support one of the statutory exceptions. If one of the statutory

exceptions exist, however, covenants not to compete may apply to professional services contracts for independent contractors as well as for employment contracts.<sup>23</sup> Valid and enforceable covenants not to compete must still have reasonable limitations for duration and geographic scope depending upon the circumstances of the particular employment or position.<sup>24</sup>

## **II. GENERAL INFORMATION ABOUT TRADE SECRETS**

Typically, an employer will use covenants not to compete with its employees in order to protect one or more of the employer's trade secrets. The definition of "trade secret" varies from state to state. In general, a trade secret consists of any formula, pattern, device, or compilation of information which is unique to the company and which provides a competitive advantage over the company's competitors who do not know it or use it. Examples of trade secrets include, but are not limited to, the following:

- Business opportunities
- Chemical and other processes.
- Compilations of information
- Contractual information
- Customer lists
- Design specifications for products
- Employee compensation information
- Financial information.
- Manufacturing methods or techniques
- New product ideas and structures.
- Pricing techniques

- Software development methods
- Supplier lists
- Training materials.

For a trade secret to exist the protected information generally must be a secret, that is, the information must not otherwise be in the public domain. In other words, the protected information must be unique to the company and not readily available from other public sources. The owner of the trade secret must also make reasonable efforts to maintain the secrecy of the protected information. A trade secret constitutes a property right and any misappropriation of the trade secret by, for example, theft or fraud, is actionable in court.

Unlike patents, copyrights, and trademarks, no federal registration or applications process exists to protect trade secrets. Therefore, state law instead of federal law controls trade secret protection. If the secrecy of the proprietary information is properly maintained, a trade secret can be indefinite in duration. Because state law controls trade secrets, however, the definition of a trade secret used by a court, and the evaluation criteria used by a court in determining whether or not a trade secret exists, can vary from state to state. The important criteria considered by most courts, including Colorado courts, includes:<sup>25</sup>

- The extent to which the information is known outside the company;
- The extent to which the information is known inside the company;
- The precautions taken by the company to maintain secrecy of the information;
- The value of the information to the company;
- The value of the information to competitors of the company;
- The amount of effort, time, and money expended by the company in obtaining and developing the information; and

- The amount of effort, time, and money required by a competitor to duplicate the information.

Of course, no single factor controls a court's decision regarding the existence of a trade secret. Obviously, if more relevant factors have factual support, then the greater the likelihood that a court will find that a trade secret exists.

### III. NON-DISCLOSURE PROVISIONS.

Courts will treat nondisclosure and non-solicitation provisions in employment contracts differently from covenants not to compete. Nondisclosure agreements allow former employees “to work for whomever they wish, and at whatever they wish, subject only to the prohibition against misusing . . . proprietary information.”<sup>26</sup> In other words, a nondisclosure agreement must be no broader than necessary to protect the former employer, but may not impose significant hardships on the employability of a former employee.<sup>27</sup> Courts will not enforce nondisclosure provisions unless the information the employer intends to protect is truly confidential or a trade secret.<sup>28</sup>

A relatively new development in the area of non-competition agreements addresses the status of employees who have acquired confidential or proprietary information during their course of employment, but are not subject to a formal non-compete or non-disclosure agreement. Under the “doctrine of inevitable disclosure,” these employees may still be prevented from obtaining employment with competitors. Thus, the doctrine has the effect of imposing a de facto non-compete agreement on certain employees. The holdings of several recent cases are instructive in determining how the courts are defining the scope of this doctrine.

- Pepsico, Inc. v. Redmond.<sup>29</sup> The Seventh Circuit Court of Appeals upheld a preliminary injunction that prevented a former high-level Pepsi manager with access

to proprietary information about Pepsi's sports drink from working in a similar position with Quaker Oats, the seller of Gatorade and Snapple. The Court found that the absence of candor by the former Pepsi manager in accepting the offer from Quaker Oats indicated a willingness to misuse Pepsi's trade secrets.

- Merck & Co., Inc. v. Lyon.<sup>30</sup> A former employee obtained employment with a competitor while still employed with the original employer. The court allowed the employment, but enjoined the use of trade secrets, noting that the employee's misrepresentations about his future plans indicated a willingness to misuse the trade secrets of the former employer.
- Uncle B's Bakery, Inc. v. O'Rourke.<sup>31</sup> A manager at bagel manufacturing plant was enjoined from working for direct competitor. As grounds for the injunction, the court noted the potential disclosure of proprietary information acquired during the course of the manager's previous employment.
- Mulei v. Jet Courier Service, Inc.<sup>32</sup> In a leading Colorado case addressing the issue of non-compete clauses in employment contracts, the court rejected a claim for breach of a non-compete agreement against an employee who had left the employer to start his own business. The court held that covenants not to compete may protect confidential information acquired during the course of employment, but not general knowledge of a business operation.

Taken together, these cases demonstrate that the doctrine of inevitable disclosure can prevent competition by a former employee under certain circumstances regardless of the terms of a written agreement. The doctrine of inevitable disclosure may prevent competition by a former employee if the new employment makes it impossible to perform the new duties without revealing the trade secrets of the former employer. These cases indicate several trends in the application of the doctrine of inevitable disclosure to a former employee's new employment:

- The industry and the employee's job duties must be very similar if not identical;
- The former employer's efforts to maintain the secrecy of trade secrets are critical to success;
- The candor of the former employee in leaving his job can be indicative of trustworthiness with the former employer's trade secrets; and

- The activities of the former employee prior to departure – such as attending meetings with, or soliciting customers for, the new employer – are important factors.<sup>33</sup>

#### **IV. NON-SOLICITATION PROVISIONS.**

Similarly, non-solicitation provisions generally attempt to prohibit former employees from soliciting the customers, or recruiting the remaining employees, of their former employers. No published opinions from the Colorado courts have addressed the enforceability of non-solicitation provisions in employment contracts since the legislature’s adoption of the non-compete provisions discussed above.<sup>34</sup> Prior to the adoption of the statute, however, the Colorado courts had generally approved non-solicitations provisions involving former customers.<sup>35</sup>

Similarly, the Colorado Court of Appeals has enforced a non-solicitation provision that prevented a former employee of a recruiting agency from soliciting known “candidates” of the former agency for a competing agency within one year after leaving employment.<sup>36</sup> Courts in other jurisdictions have considered non-solicitation provisions for customers of the former employer as less onerous than covenants not to compete, and have generally enforced reasonable non-solicitation provisions.<sup>37</sup> Reasonable non-solicitation provisions generally must protect a specific interest of the employer, and must have a limited duration and a limited geographic scope.

Likewise, the Colorado courts have not addressed the enforceability of non-solicitation provisions involving other employees of the former employer. Other jurisdictions have enforced non-solicitation provisions involving other employees as long as those provisions had limited duration and geographic scope.<sup>38</sup>

## V. CONCLUSIONS.

The legal complexities surrounding non-compete, non-disclosure, and non-solicitation provisions requires considerable care and creativity in drafting contracts with enforceable provisions. Those contracts occasionally become even more complicated when the employment contract arises from “the purchase and sale of a business or the assets of a business” such as the purchase of a physician’s medical practice.<sup>39</sup> Consequently, employers and their legal advisers should undertake a careful review of the nature of their underlying business operations, and the expected duties of key employees, before entering into written employment agreements that attempt to restrict the actions of employees after their separation from employment.<sup>40</sup>

### AUTHORITIES

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<sup>1</sup> The authors acknowledge the assistance of Taylor T. Pollock, /Esq. and Carrie Lynn H. Okizaki, the firm’s law clerk, in preparing these materials.

<sup>2</sup> Colo. Rev. Stat. § 8-2-113(2) (1999)

<sup>3</sup> Neil Caesar, J.D., “A Too-Tough Noncompete Clause Could Defeat Its Own Purpose” Managed Care Magazine (Nov. 1996).

<sup>4</sup> Colo. Rev. Stat. § 8-2-113(2).

<sup>5</sup> Id.

<sup>6</sup> Colo. Rev. Stat. § 8-2-113(3).

<sup>7</sup> 651 P.2d 464 (Colo. App. 1982).

<sup>8</sup> Colo. Rev. Stat. § 8-2-113(3); see also Wojtowicz v. Greeley Anesthesia Services, 961 P.2d 520 (Colo. App. 1997) (cert. dismissed as improvidently granted and reh’g denied, Oct. 4, 1999); cf. Turner v. Four Corners Heart Clinic, P.C., No. 94 N 1394 (D. Colo., Jan. 17, 1995).

<sup>9</sup> Colo. Rev. Stat. § 8-2-113(3).

<sup>10</sup> See Colo. Rev. Stat. §§ 12-36-106(1).

<sup>11</sup> See generally Colo. Rev. Stat. § 12-36-106(2).

<sup>12</sup> See Colo. Rev. Stat. § 8-2-113(2).

<sup>13</sup> Colo. Rev. Stat. §§ 12-36-106(3)(a) to (u).

<sup>14</sup> Colo. Rev. Stat. § 8-2-113(2).

<sup>15</sup> Colo. Rev. Stat. § 8-2-113(3).

<sup>16</sup> Colo. Rev. Stat. § 12-36-134(1).

<sup>17</sup> Colo. Rev. Stat. § 25-3-103.7(2).

<sup>18</sup> Colo. Rev. Stat. § 8-2-113(3).

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<sup>19</sup> 961 P.2d 520 (Colo. App. 1997) (cert. dismissed as improvidently granted and reh'g denied, Oct. 4, 1999).

<sup>20</sup> Code of Medical Ethics, xv (American Medical Association, Council on Ethical and Judicial Affairs, 1998-99 ed.) (Fundamentals of the Patient-Physician Relationship); see also id. at 141 (Ethics Opinion 8.115, Termination of the Physician-Patient Relationship) (“Physicians have an obligation to support continuity of care for their patients”).

<sup>21</sup> Id. at 158 (Ethics Opinion 9.02, Restrictive Covenants and the Practice of Medicine).

<sup>22</sup> The Colorado Board of Medical Examiners apparently considers the American Medical Association’s Ethics Opinions as the generally accepted standards of practice for physicians practicing in Colorado. The Board of Medical Examiners has authority to impose discipline on a physician for “[a]ny act or omission which fails to meet the generally accepted standards of medical practice[.]” Colo. Rev. Stat. § 12-36-117(1)(p).

<sup>23</sup> Colorado Supply Co. v. Stewart, 797 P.2d 1303 (Colo. App. 1990); but see Smith v. Sellers, 747 P.2d 15 (Colo. App. 1987) (refusing to enforce a covenant not to compete in an independent contractor agreement in which one dentist provided independent services in the office of another dentist).

<sup>24</sup> See In re Marriage of Fischer, 834 P.2d 270, 273-74 (Colo. App. 1992) (non-competition with related business within 20 highway miles upheld); Harrison v. Albright, 577 P.2d 302, 304-05 (Colo. App. 1977) (citing “[n]umerous appellate decisions [that] have sustained covenants not to compete for terms of up to five years and within distances of 100 miles” in upholding a five year, 50 mile, non-competition provision); but see Earthweb v. Schlack, No. 99 Civ. 10035, 1999 U.S. Dist. Lexis 16700 (S.D.N.Y. Oct. 27, 1999) (“When measured against the information technology industry in the Internet environment, a one-year hiatus from the work force is several generations, if not an eternity”).

<sup>25</sup> See Network Telecommunications v. Boor-Crepeau, 790 P.2d 901 (Colo. App. 1990); Porter Industries v. Higgins, 680 P.2d 1339 (Colo. App. 1984).

<sup>26</sup> MAI Basic Four, Inc. v. Basis, Inc., 880 F.2d 286, 288 (10th Cir. 1989).

<sup>27</sup> Electrical Prods. Consol. v. Howell, 117 P.2d 1010, 1012 (Colo. 1941); see also Boettcher DTC Bldg. Joint Venture v. Falcon Ventures, 762 P.2d 788, 790 (Colo. App. 1988) (even after separation from employment “an agent owes a continuing duty not to use or disclose confidential information obtained during the course of the agency”).

<sup>28</sup> See Metro Traffic Control, Inc. v. Shadow Traffic Network, 22 Cal. App. 4th 853, 27 Cal. Rptr. 2d 573 (Cal. App. 1994).

<sup>29</sup> 54 F.3d 1262 (7<sup>th</sup> Cir. 1995).

<sup>30</sup> 941 F. Supp. 1443 (M.D.N.C. 1996).

<sup>31</sup> 920 F. Supp. 1405 (N.D. Iowa 1996).

<sup>32</sup> 739 P.2d 889 (Colo. App. 1987).

<sup>33</sup> M. Fagin, “Non-compete by Non-disclosure: The Doctrine of Inevitable Disclosure,” 28 Colo. Law. 73, 75 (Sept. 1999).

<sup>34</sup> Colo. Rev. Stat. § 8-2-113(2).

<sup>35</sup> See Colonial Life & Accident Ins. Co. v. Kappers, 488 P.2d 96 (Colo. App. 1971).

<sup>36</sup> See Management Recruiters of Boulder, Inc. v. Miller, 762 P.2d 763, 765 (Colo. App. 1988).

<sup>37</sup> See, e.g., Alpha Tax Serv., Inc. v. Stuart, 761 P.2d 1073 (Ariz. App. 1988).

<sup>38</sup> See, e.g., Loral Corp. v. Moyes, 219 Cal. Rptr. 836 (Cal. App. 1985) (employee non-solicitation clauses are generally valid if reasonable in scope); but see Cap Geminie America, Inc. v. Judd, 597 N.E.2d 1272 (Ind. App. 1992) (refusing to enforce overbroad non-solicitation provision); Robinson v. Jardine Ins. Brokers Int’l Ltd., 856 F. Supp. 554 (N.D. Cal. 1994) (same).

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<sup>39</sup> Colo. Rev. Stat. § 8-2-113(2)(a); see also J. Patterson & J. Funk, “Covenants Not to Compete in the Sale of a Business: Protecting Goodwill,” 26 Colo. Law. 31, 33 (Dec. 1997).

<sup>40</sup> See B. Garofalo & M. Fishberg, “Trade Secrets: Noncompete Agreements”, The National Law Journal (Jan. 17, 2000), at B7.