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Primer on Non-Compete Agreements and Restrictive Covenants

An Overview of Wisconsin Law

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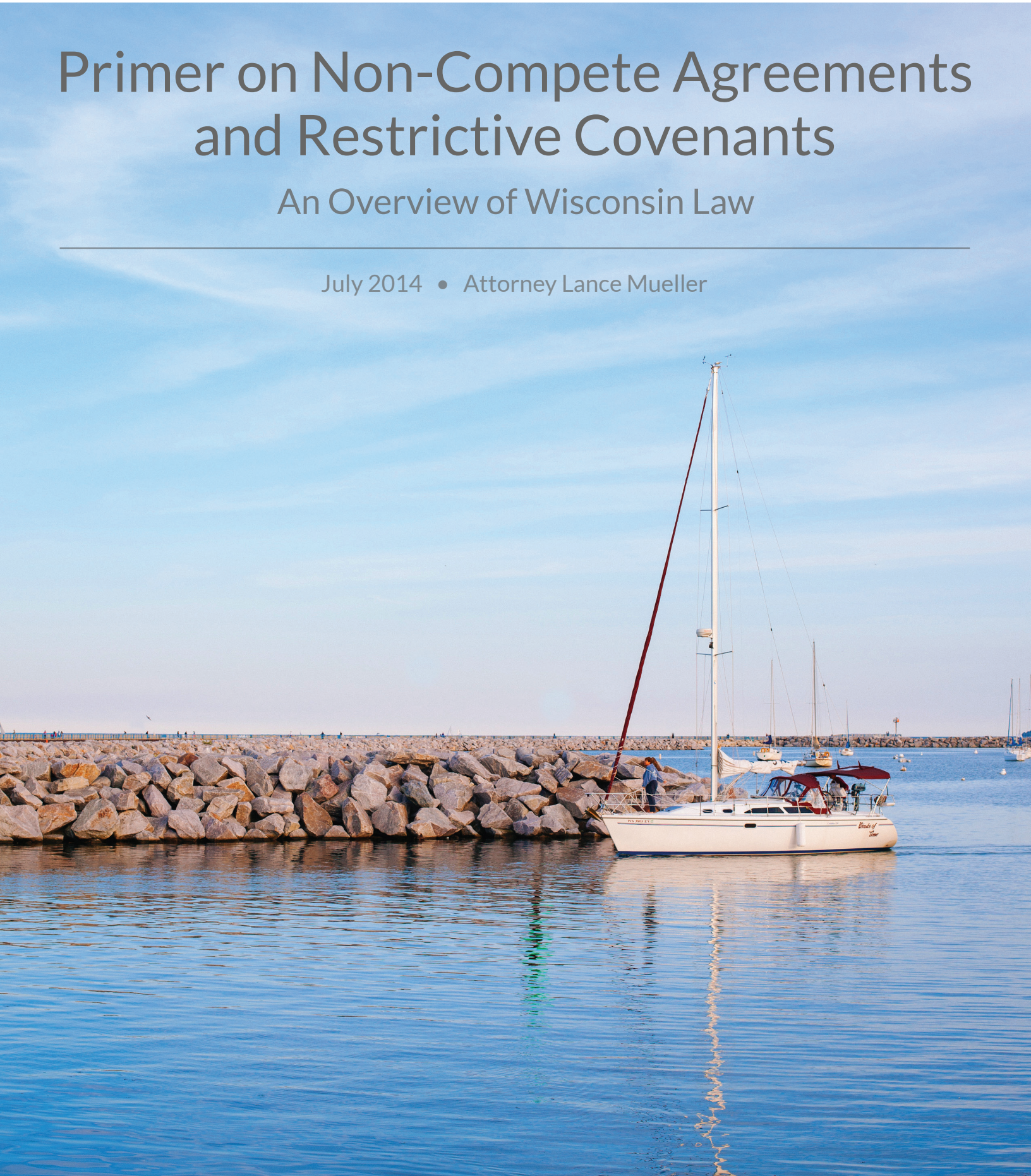

Non-compete agreements and restrictive covenant terms are a constant topic of conversation for business attorneys, owners and employees. At some point in time most companies must evaluate whether or not they need certain owners, employees or agents to enter into non-compete contracts. Further, they often encounter prospective employees that had signed a non-compete with a former employer or are subject to a restrictive covenant in some form of agreement. At the same time, many employees question the validity and enforceability of restrictive provisions that they find, among other places, in employment, severance, confidentiality or non-disclosure agreements that they have signed during the course of work. The purpose of this guide is to provide an overview of the law as it pertains to certain aspects of restrictive covenants in Wisconsin, and useful information regarding commonly asked questions.

Generally speaking, a non-compete agreement refers to a contract that is designed to prevent one party from taking part in certain business activities, typically limiting their ability to compete in some fashion. A "*restrictive covenant*" or a "covenant not to compete" is essentially the same thing, but typically refers to a particular clause or provision found in a contract of any kind that has the same purpose – to limit the business activities of some individual. A restrictive covenant might be a single clause in a confidentiality agreement for example. Whatever the name and wherever they may be found, most attempts to limit the business activities of another in the context of employment are analyzed the same for legal purposes.

Accordingly, the terms "restrictive covenants," "covenants not to compete" and "non-compete agreements" are largely used interchangeably in this Primer.

A. The Enforceability of Restrictive Covenants

Wisconsin has enacted a statute applicable to restrictive covenants. Found at Wisconsin Statute § 103.465, it provides in relevant part:

A covenant by an assistant, servant or agent not to compete with his or her employer or principal during the term of the employment or agency, or after the termination of that employment or agency, within a specified territory and during a specified time is lawful and enforceable only if the restrictions imposed are reasonably necessary for the protection of the employer or principal. Any covenant, described in this subsection, imposing an unreasonable restraint is illegal, void and unenforceable even as to any part of the covenant or performance that would be a reasonable restraint.

Thus, a restrictive covenant is enforceable only if it is (1) limited to a specific territory and time and (2) reasonably necessary for the protection of the employer. There are a number of factors that are considered in making such a determination. Specifically, Wisconsin Courts have decided that enforceability of these agreements will depend upon: (1) the employer's need for the restriction; (2) the length of the restriction; (3) the scope of the territory and activity being restricted; (4) reasonableness to the employee; and (5) reasonableness to the general public.

1. Employer Need

It is important for businesses to understand that they will be required to prove that any covenant that they seek to enforce is actually necessary. Courts will not enforce restrictive covenants if they seek to protect the business from ordinary competitive activities in which any stranger to the business could engage.

There are two common justifications for these agreements. First, an employee or salesperson has developed such a relationship with the customers

of a business that the customers associate the goodwill of the company with the individual rather than the organization. This is generally known as the "*customer contacts*" basis for enforcement. Second, an employee has access to the confidential information that would give the employee a competitive advantage. This is the "*confidential information*" basis for enforcement.

Any employer must carefully consider the purpose any restrictive covenant will serve and make sure that it is tailored to a specific and legitimate business need.

2. Length of Restriction

A restrictive covenant may only be binding for a "*reasonable*" period of time following employment. What amount of time is reasonable? There is no flat rule, and what is reasonable is determined on a case-by-case basis. However, it is clear that having no time limit will render the covenant unenforceable. Also, based upon a number of court decisions it appears that *two years is a reasonable duration*.

As a practical matter, employers that include a covenant shorter in duration stand a greater chance that it will be enforced. The longer the restriction the more risk the agreement could be invalidated.

Two years may not seem like a particularly long period of time. However, employers should carefully consider whether that time period might be more effective than thought at first blush. In most cases the answer is probably "*yes*." If the employee has no contact with customers for many months it is unlikely that the customers will continue to associate company goodwill with that individual, particularly if the business is proactive in addressing the transition.

Similarly, much confidential information will change over time such that the advantage a former employee would derive will decrease. Moreover, if the information being protected is a trade secret or other critical information a longer duration may be justified. In fact, courts have found the absence of a time limit reasonable in the context of a non-disclosure agreement.

3. Specific Territory

Although the statute referenced above indicates that restrictive covenants must be limited to a "*specific territory*" the law has evolved to the point that "specific territory" does not refer simply to a geographic area. Rather, a restrictive covenant must be limited either to a specific geographic area or certain activity relating to particular groups of customers or contacts. No matter the method of determining territory, it must be reasonable. Moreover, both geography and customer contacts will be scrutinized for reasonableness if both limits are used to define territory in a particular agreement.

For restrictions based upon *customer contacts*, a basic rule is that any restriction extending beyond the territory actually served by the employee will

be considered unreasonable. At a minimum it is likely that a restriction should be limited to actual territory served.

An employer may also wish to consider where its customers are located and limit all activity within a specific radius of its place of business if the location plays an important role in the business. Again, the smaller the radius the greater likelihood the restriction will be enforced, particularly if the business has data to prove where its customers come from.

As noted, another consideration is whether to restrict contact with certain groups or contacts rather than rely on geography. It is critical, however, that the employer distinctly defines the exact scope of the restriction.

Regardless of the method used to define territory *an employer must also carefully describe and limit the activity prohibited to that reasonably necessary to protect the business*. For example, one court found a restrictive covenant that would have prevented a salesperson from taking a job as a janitor with a competitor unreasonable. Prohibiting accepting a job as a salesperson with the competitor probably would have been upheld as reasonable and served its purpose.

The same limitation might not apply when a restriction is based upon access to confidential information as opposed to customer contacts. If a former employee could take sensitive information to a competitor a restriction limiting more types of employment might be appropriate.

Again, the key issue is whether or not the limitation is reasonably necessary to protect the employer. The precise facts and circumstances of each case must be taken into consideration and any restrictive covenant carefully drafted.

4. Reasonableness to Employee

In deciding whether or not a restrictive covenant will be enforced courts will look at whether or not the agreement would inhibit an employee's "*ability to pursue a livelihood*." Of course virtually every agreement that limit an individual's ability to engage in certain business activities limits that individual's employment options and thus reduced the ability to pursue a livelihood. Therefore, the focus is on the totality of the circumstances and whether or not the burden is unreasonable.

Some of the factors that a court will consider include the number of available employment opportunities, general economic conditions, the employee's education, physical condition and age. This factor could serve to render a covenant unenforceable if, for example, the employee has highly specialized knowledge valuable only in a particular field and, given the limited field of competition, there are very few alternative employment options available.

5. Reasonableness to Public in General

There is a limited amount of legal authority regarding what an evaluation of reasonableness to the general public might entail, and most cases are determined on the basis of the four factors described above. Nonetheless, an agreement that unduly limits competition or lends itself to a monopoly could serve as a basis to arguably render it unenforceable. Limiting a particular type of service available in a particular area might also be a detriment to the public, or perhaps the impact on customers or others who dealt with the former employee would weigh against enforcement.

B. Other Legal Issues Relating to Enforcement

The law described above and the factors that a court will consider in determining whether or not a non-compete agreement should be enforced are of paramount importance in drafting a solid restrictive covenant. However, there are a number of issues that arise in connection with such agreements that do not necessarily go to the heart of the fairness or reasonableness of the restriction. Although the following issues are more procedural in nature, they can affect the enforceability of a restrictive covenant and should be given due consideration.

1. Consideration

A basic rule of contract law is that an agreement must be supported by sufficient consideration to be binding. The idea of "*consideration*" refers, generally, to some legal benefit or something of value given in exchange for a promise to be bound by contract. In other words, the party agreeing to be bound by the restrictive covenant must receive something of value in exchange for doing so.

This could become an issue where an employee or group of employees is asked to sign a non-compete at some point after they have become employees and during the course of their employment. An employee could contend that an agreement signed during that time lacked consideration as they received nothing of value. There are a couple of responses to this from the standpoint of the employer. First, an employer could consider paying some form of bonus or conferring some kind of benefit in exchange for the agreement. Generally, even if small, the concept of providing the requisite consideration will be satisfied. Second, the employer might assert that continued employment was the consideration. If that is the case, the employer should be prepared to prove the employee would have been terminated had the agreement not been signed.

There is at least one Wisconsin court case in which a non-compete agreement was found unenforceable for lack of consideration. An employer attempted to impose a restrictive covenant on an employee after she had been hired and during training. The employer did not require all employees to sign restrictive covenants and had no proof that there would have been consequences had the employee in question failed to do so.

2. Fraud

An issue that can arise with contracts of any type is the allegation that entry into the agreement was induced by fraud. That is, an employee could claim that an individual misrepresented the nature or impact of the non-compete agreement. To succeed on such a claim and invalidate a restrictive covenant, the party against whom enforcement was sought would have to show: (1) the individual or entity presenting the non-compete misrepresented the significance of the agreement; (2) the signer relied upon the misrepresentation; and (3) that reliance was reasonable under the circumstances. Clearly, the lesson for any employer requiring a non-compete be signed exercise caution

in discussing the agreement with the signing party and encourage the signer to have the agreement reviewed by independent legal counsel.

3. Breach of Contract

In some circumstances a breach of contract by one party excuses the other party from performing his or her obligations under the contract. In other words, if an employer was guilty of some breach with regard to an agreement containing a restrictive covenant the employer may not be able to enforce that provision. For example, if a business terminates an employee in a manner inconsistent with the terms of an employment contract or does not provide benefits that might have been promised, the employee may assert that the business breached an agreement first, such that a restrictive covenant cannot be enforced. Along these lines, terminating an employee in bad faith could be a reason for a court not to enforce a restrictive covenant.

4. Assignment

This is a somewhat technical legal issue that could arise in the event that a business is sold or reorganized such that the individual business entity that might have signed the non-compete agreement is no longer the business entity that wants to enforce the agreement. Suppose ABC Corp. entered into a non-compete with its employee, and subsequently sold its business to DEF Corp. Perhaps ABC Corp. no longer cares about the non-compete, but DEF Corp. probably does have an interest in the agreement. The question is whether or not DEF Corp. could enforce the contract. Or, suppose that a sole proprietorship that has a signed non-compete with an employee incorporates, or a corporation forms a new legal entity to operate as a separate business or subsidiary. Any of these events that might cause one of the parties to an agreement to no longer be the party primarily interested in enforcing the agreement implicate the legal issue of assignment.

A non-compete agreement is a contact for personal services between the two parties. That is, the individual signing the agreement is agreeing personally to either take action or refrain from taking action. Generally, a party to a contract may assign their rights under the agreement but cannot assign the personal obligation to fulfill whatever responsibilities the party may have in connection with the contract. That personal obligation cannot be assigned without consent.

There is no clear rule on the legal enforceability of assignments when it comes to non-compete agreements in Wisconsin. The contract itself should address this issue and it should be considered in the context or any business sale or transition.

C. Specific Occupations

At times there are questions regarding the enforceability of non-compete agreements as they apply to certain types of professions. In particular, they arise in the context of *doctors*, *dentists*, *accountants*, *veterinarians* and *insurance agents*. The primary reason for this is that restrictive covenants are often used in these professions.

In fact, Wisconsin law does not generally restrict non-compete agreements with doctors, dentists, accountants, veterinarians or insurance agents. There are a number of Wisconsin court cases that address the legality of such agreements as they apply to doctors and dentists. As a result, it is clear that restrictive covenants can be enforced with respect to professionals in these fields, but it is equally clear that such agreements must be carefully drafted and properly tailored to withstand scrutiny.

Interestingly, there is the possibility that agreements with doctors and dentists may be subject to challenge on grounds that they might not be reasonable to the public in general, the fifth factor described above on which courts have offered little guidance. There may be at least a couple of reasons for this. First, restrictive covenants generally may not be applied to attorneys to restrict their active practice for the reason that it "limits the freedom of clients to choose a lawyer." The same argument can be made when it comes to these other professions. Second, the American Medical Association has issued an opinion "discouraging" non-compete agreements as they relate to doctors, and the American Dental Association's professional code urges that patients be able to choose their dentist "without any type of coercion." Again, these principles could factor into any consideration relative to the reasonableness to the public when evaluating a non-compete.

D. The Scope of Law Concerning Restrictive Covenants

Non-compete agreements are most notorious in the context of an employment relationship. Employers often require employees to sign standalone non-compete contracts. Other times restrictive covenants are found as contract provisions in employment agreements or other types of contracts between employers and their employees.

Of course restrictive covenants arise in the context of other types or relationships or agreements. The issue then becomes whether or not the provisions found in different non-employment type situations are subject to the same scrutiny and analysis referenced above. The party seeking to avoid the restrictive covenant will argue that those more exacting standards apply, while the party seeking to enforce the covenant argues that traditional less strict contract principles govern.

With that in mind, some of the other areas where restrictive covenants may be found include the folllowing:

1. Contracts with Independent Contractors.

Some court cases suggest that the analytical framework above applies in this context. There might be an argument that it does not apply if personal services are not involved.

2. Contracts relating to the Sale of a Business.

Generally these will not be subjected to the same high level of scrutiny associated with the various factors described above. In other words, one might be able to bargain for greater restrictions in the context of a business sale as opposed to a mere employment relationship. The theory is that the purchaser is bargaining for greater rights in connection with the transaction and has bargaining power equal to that of the seller, rather than an employment relationship where an employee may have little to no ability to negotiate.

3. Business Ownership Agreements.

It is likely that restrictive covenants found in agreements among business owners will not be subject to the level of scrutiny described above. Again, the notion is that business owners have equal bargaining power when negotiation any transaction. There are no determinative court rulings on this issue. Further, there are many arguments to be made that the heightened level of scrutiny should apply depending upon the specific set of facts and circumstances of any given case. For example, if an employee is given ownership in a partnership and signs a non-compete in connection with the transaction it might be arguable that the framework of Wis. Stat. § 103.465 should apply.

4. Confidentiality and Non-Disclosure Agreements.

The answer here is that these agreements will be subject to analysis under Wis. Stat. § 103.465. However, as noted above, the specifics of a given case may weigh in favor of greater limitations (bigger territory, longer term and so forth) being deemed reasonable. Specifically, if trade secrets are being protected, a restrictive covenant with no

time limit may be reasonable, which might not be the case if less sensitive information is being protected.

5. Benefits.

One should use caution is drafting any agreement that could result in the forfeiture of future benefits or the payment of a penalty for future competition. For example, requiring a sales person to surrender commissions or otherwise require an employee to surrender some benefit could be subject to heightened scrutiny as a restrictive covenant even though the agreement on its face appears to have little to do with expressly prohibiting competition.

E. Enforcement

A business seeking to enforce a restrictive covenant will typically seek money damages and an injunctive prohibiting the employee from violating the terms of the agreement.

An injunction is essentially a court order directing that the not engage in the activity prohibited by the restrictive covenant's terms. A temporary injunction may be issued within days of seeking court intervention and can be issued if the party seeking relief shows (1) a reasonable probability of success on the merits, that (2) it has no adequate remedy at law, and (3) it will suffer irreparable harm if an injunction is not issued. A temporary injunction is limited in duration and, at most, will last until there is a trial on the merits of the case. If the party initially seeking the injunction prevails, the court may issue a permanent injunction.

Money damages for breaching a non-compete can be difficult to calculate. The party seeking to enforce the agreement will need some evidence to tie a monetary amount lost to the breach. This could come in the form of money expended trying to maintain goodwill or a customer base, for example.

Because of the difficulty associated with determining the amount of monetary loss resulting from the breach of a restrictive covenant parties have at times included what are known as liquidated damages provisions in an agreement. A liquidated damages clause simply means that the parties agree in advance on a specific damage amount in the event of a breach. Liquidated damages clauses can be tricky. To be enforceable they must represent an estimate of actual damages rather than a penalty, be capable of estimation at the time the contract is made, and represent a "reasonable forecast" of the likely harm.

F. Employer Considerations

Every business must evaluate whether or not to implement a non-compete agreement or include restrictive covenants in contracts with certain employees at some point in time. Some companies believe that there is no need for such agreements, viewing a problem like an employee leaving and taking business as something that will not happen to them. Also, they sometimes feel awkward about asking employees with close relationships to the business to sign such agreements for fear of insult.

In fact, these types of contracts are a regular part of business life. Most employees understand as much. Further, the agreements can be presented in connection with a bonus or some other benefit to smooth the process. There are countless instances in which businesses without a non-compete in place lose an important employee to a competitor. Not only do they find themselves scrambling to recover from the personnel loss, they must deal with the potential loss of customers and revenue. There might be little that can be done without a restrictive covenant in place to mitigate the damage. Further, non-competes can be structured so that they limit the degree of surprise associated with the loss of an important employee. The bottom line is that they add value to a business by increasing the stability of the workforce and protecting valuable company assets and information.

In evaluating the propriety and status of any restrictive covenant a business should consider the following:

1. Identify the important individuals in the organization and think about what would happen if they left.

Why not consider using non-competes, at least selectively? There is little downside. The extent to which the contracts are enforced if something happens in the future can be decided at the time.

2. Have any non-competes or restrictive covenants in place been prepared by legal counsel?

This is really a specialized area of the law that does not lend itself to do it yourself forms or copying and pasting something from the Internet. As the above discussion should illustrate, an agreement that might work in one instance might not work for another. In fact, even an agreement that might work for one employee might not work for another within the same organization.

3. Have any non-competes or restrictive covenants been recently reviewed by legal counsel?

There are many court cases filed each year in both state and federal courts over non-competes. Many courts issue rulings that either directly impact the ability to enforce restrictive covenants or provide valuable guidance on how to ensure that such agreements are enforceable. Legal counsel should review any non-compete agreements or restrictive covenants on an annual basis to ensure that they remain consistent with the current state of the law. The review does not have to be expensive, as an attorney with experience in the area will simply be able to evaluate any agreement in light of new developments and consider changes where appropriate.

4. Are new hires or prospective hires a party to a non-compete?

This could factor into the employment decision. Businesses want to avoid bringing on a new employee and getting threatened with a lawsuit. Ask about this when screening potential employee prospects. It is important to understand that a company seeking to enforce a non-compete with a former employer sometimes threatens suit against the new employer on grounds that they are interfering with the non-compete agreement.

G. Employee Considerations

Some employees seek legal advice before signing a non-compete. The vast majority, however, do not.

They typically refrain from doing so because it may be too expensive or they want or need the job regardless and will sign what they must. As a result, most seek guidance when they are thinking about switching jobs, receive a severance package from an employer, or are threatened with the enforcement of an agreement they signed. In some instances, they forgot about the fact that they might have signed something several years before.

An attorney reviewing a non-compete will consider the circumstances and often work through the factors described above to assess whether the agreement might be unenforceable. They look for a way to "*break*" the non-compete. Unfortunately, because disputes over restrictive covenants can be so fact specific it can be difficult to predict exactly what a court would do in a particular situation. However, while many attorneys often find it hard to provide the definitive "*yes*" or "*no*" the employee wants, so many businesses use do-it-yourself forms or outdated contracts that there are many instances in which a clear answer is possible.

Looking at the factors discussed above, those regarding reasonableness to the public, employee and the employer necessity do not lend themselves to a quick and certain answer regarding whether or not an agreement would be enforceable. Thus, the initial focus is often on the time component and the territorial restriction. *The territorial restriction is the area in which most employers slip up*. Specifically, they tend to be overly broad in terms of the group a former employee must avoid or the types of jobs with competitors from which a former employee might be restricted.

Legal counsel can also review details regarding the agreement and explore issues such as fraud, consideration and perhaps assignability with a view toward identifying any potential weakness in the agreement. Generally the attorney can provide the employee with an overview of the risks associated with various courses of action.

The employee should also consider whether or not a new employer might be involved in the process. In some situations the new employer will insist that the employee obtain a legal opinion regarding the enforceability of any agreement. In others they might actually agree to have their attorneys review the agreement and provide an opinion. Also, some contracts actually require employees to provide a copy of such agreements to the new employer.

Any employee that signs a non-compete should retain a copy for future reference. Further, they should think ahead and keep the agreement in mind when looking for a new job or considering a change.

In conclusion, it is important to seek quality legal advice in these types of situations. Leaving one job only to find out that you cannot legally accept another, or that your former employer can tie you up with expensive and stressful litigation for years can be devastating. Internet research alone will often be inadequate because of the frequency of legal developments and the highly fact specific nature of the legal analysis necessary to provide an opinion and meaningful guidance.

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ABOUT LANCE MUELLER

Lance Mueller is a trial lawyer and the founding owner of Mueller, S.C. He has significant experience in both state and federal courts around the country litigating cases involving business matters, including non-compete agreements and restrictive covenants. He advises businesses regarding the enforceability of their non-competes and aids them in managing risk and protecting business value through the careful use of restrictive covenants. He also represents individuals in lawsuits involving covenants not to compete and helps them avoid enforcement of non-competes.

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