

COVENANTS-NOT-TO-COMPETE

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I. INTRODUCTION AND OVERVIEW

Covenants-not-to-compete and the related subject of protection of intellectual property assets commonly appear in two commercial contexts. First there is the familiar employer-employee relationship wherein the employer binds the employee from any competition after termination of employment and may also restrict the use of certain intellectual property assets owned by the company and used and/or created by the employee during employment. By far, this is the most common area in which covenants-not-to-compete are implemented and litigated.

The second commercial area involves the sale of a business. The seller agrees that after consummation of the sale, it will refrain from competition with the buyer and will not use any of the intellectual property assets that are transferred or assigned by the seller to the buyer in the course of the transfer of the business as a whole.

A. Competitive Context

A general observation may be made that the courts are more solicitous regarding the strict enforcement of covenants-not-to-compete in an employer-employee context than in the sale of a business. Alexander & Alexander, Inc. v. Danahy, 488 N.E.2d 22 (Mass. Ct. App. 1986); American Hot Rod Ass'n v. Carrier, 500 F.2d 1269 (4th Cir. 1974). The reasons are fairly easy to discern as to why the courts apply a more liberal interpretation to a business transaction than to an employer-employee relationship. It can be easily assumed that there is more vigorous arms-length bargaining between the buyer and seller of a business than between an employer and an employee. Furthermore, it is easier to see that if the seller reenters competition with the buyer of the business, the seller has effectively impaired or destroyed part of the value, particularly the goodwill, that he purported to transfer with the business as a whole. It is also true that legislatures have been more prone to protect employees. Colo.Rev.Stat. § 8-2-113 (limiting non-compete agreements in the employment relationship to narrowly defined circumstances).

B. Competing Interests

The sole reason why this area of contract law draws particular scrutiny from the courts is because of the perceived public interest in what is nominally a private transaction. On the one hand, the United States remains -- indeed may be the very quintessence of -- a free market economy. Innumerable laws, not the least of which are laws against restraints on trade of which the antitrust laws are a species, confirm that the public has an interest in lively if not vigorous competition between suppliers of goods and services. It follows that any action between two suppliers of goods or services, or between a supplier and a potential supplier, that will reduce the number of competitors in the field, may constitute a restraint on trade that encroaches on free competition. Thus, like other private agreements that by their very purpose result in a lessening of competition, covenants-not-to-compete warrant close scrutiny by the courts.

A countervailing consideration is the once sacred and now somewhat attenuated doctrine of freedom of contract. As stated in Lovelace Clinic v. Murphy, 76 N.M. 645, 417 P.2d 450 (1966):

The public has an interest in seeing that competition is not unreasonably limited or restricted, but it also has an interest in protecting the freedom of persons to contract, and in enforcing contractual rights and obligations.

Id. at 650. It follows that courts will only circumscribe the rights of the parties to freely contract where it can be shown that the competing interest, i.e., the public interest in free competition, is not insubstantially affected.

Implicit in the freedom to contract consideration is that an employer may have a valuable interest in entering into an agreement in which it seeks to protect its assets against any potential devaluation of such assets which may result from the relationship between employer and employee. The covenant-not-to-compete, as explained below, is conceptually distinct from protection of intellectual property rights.

The covenant-not-to-compete may be seen more as a protection of company goodwill. Of course, that goodwill is embodied in the relationships of the company with its customers, suppliers, financing sources, business partners, and a wide variety of other third parties that together constitute the “goodwill” of the business. Thus, a covenant-not-to-compete is a rational action on the part of an employer to preserve the goodwill it acquires both before and during the employment relationship as a result of the daily operation of its business. Just as time, effort and money is expended to create intellectual property assets, time, effort and money are expended to create, secure and maintain the myriad relationships between the company and third parties that comprise the goodwill of the entity. It is this expenditure of time, money and effort which the employer is attempting to protect through the use of a covenant-not-to-compete. And it is the recognition of this property interest that warrants or underlies the rationale that the employer should have the freedom to contract with an employee who may affect such property. In the context of a sale of a business, the same considerations come into play, only it is the buyer of the business who is interested in protecting the goodwill that it has purchased as part of the ongoing business.

The validity of covenants-not-to-compete in the State of New Mexico, as well as recognition that a covenant-not-to-compete may prevent fair competition, not only unfair competition, is set forth in Lovelace Clinic v. Murphy, 76 N.M. 645, 417 P.2d 450 (1966). The case involved a doctor who had entered into three consecutive five-year contracts with the Lovelace Clinic while in its employ, each of which included a covenant that precluded the doctor from competing within Bernalillo County for a period of three years after termination of his employment with the clinic. Dr. Murphy on his own instance terminated his association near the end of the third consecutive five-year employment term.

One of the primary arguments raised by Dr. Murphy was that the only legitimate purpose of the contract provision was that of preventing the employee from taking unfair advantage of his employer, such as by divulging trade secrets, soliciting

customers, or indulging in other unfair acts. In other words, the doctor argued that the covenant-not-to-compete could do not more than prevent unfair competition, that is, permit the enforcement of only legally enforceable rights which exist independently of the covenant. The court expressed its disagreement with this argument by stating: “[t]his reasoning could lead only to the conclusion that a covenant like the one here involved is meaningless, and that no legal rights and duties can arise from such a covenant.” Id. at 648. The court stated that it had reviewed myriad cases involving covenants-not-to-compete by physicians or surgeons and that in only four cases were these covenants not enforced. Discussing each case, the court pointed out that the reason for non-enforcement was that the scope of the restriction was too broad. The court noted: “[t]he relief sought was not denied in any one of these four cases because the right sought to be enforced did not exist independently of the contract provisions.” Id. at 649. The court then noted that the question of reasonableness “. . . is not related to or dependent on the existence of a legally-enforceable right or duty independent of the rights and duties created by the contract of employment or association.”

The court further relied upon its earlier decisions in Excelsior Laundry v. Diehl, 32 N.M. 169, 252 P. 991, and Nichols v. Anderson, 43 N.M. 296, 92 P.2d 781, for the proposition that “. . . restrictive covenants in employment contracts, wherein the restraints imposed are reasonable, create legally enforceable rights and duties apart from the rights and duties that would be so enforced in the absence of such covenants” (Emphasis added).

The court then responded to Dr. Murphy’s additional argument that the covenant tends to eliminate or restrict competition and in many instances could operate to compel the employee to remain in the employ of the employer. The court pointed out that these are usually the main purpose of the covenant and are a legitimate purpose, so long as the restrictions are reasonable. The court noted: “[t]he public has an interest in seeing that competition is not unreasonably limited or restricted, but it also has an interest in protecting the freedom of persons to contract, and in enforcing contractual rights and

obligations.” The case is a reminder that there was a time when freedom of contract in the United States was not immediately defeated by a cry that the public interest was involved.

Finally the court responded to Dr. Murphy’s arguments that the hardships imposed upon him outweighed the benefit to the clinic, stating that he had taken for his own gain the benefits of his association with the clinic for many years. The court noted that while equity may refuse to enforce contracts if great hardships will be imposed only in return for relatively small benefits, the case law clearly shows that covenants against solicitation had been almost unanimously enforced by numerous courts over a substantial period of time.

C. Covenants-Not-to-Compete and Related Protection

As intimated above, from an analytical viewpoint, the covenant-not-to-competes is distinct from other types of protection of intellectual property rights. “Intellectual property” is a broad category of intangible assets that includes both statutory and common law created and protected rights. In the statutory category, there are of course patents, trademarks, copyrights, maskworks, and in certain foreign countries variations of these familiar government grants of limited monopolies. In the non-statutory category, there are such rights as trade secrets, confidential business information, and proprietary information, which for purposes of this article are subsumed under the title “trade secrets”.¹

¹ New Mexico has adopted the Uniform Trade Secrets Act (NMSA §57-3A-1 through 57-3A-7) (Appendix A). Many people think of trade secrets as comprising “technical information,” but the definition in the statute and increasingly in court opinions and notes of commentators recognize that the term “trade secret” is much broader in scope. As stated in Section 57-3A-2, “. . . ‘trade secret’ means information, including a formula, pattern, compilation, program, device, method, technique or process that: 1) derived independent economic value, actual or potential from not being generally known to or not being readily ascertainable by proper means by other persons who can obtain economic value from its disclosure or use; and 2) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.” It may therefore be seen that a method of doing business, the compilation of information required for a bid, a compilation of customer names and needs, a technique for pricing, and similar non-technical activities are readily encompassed within the term “trade secret”. See Appendix B for a non-exhaustive list of types of “trade secrets”.

The important conceptual distinction between what is protected by a covenant-not-to-compete, goodwill, and what is protected through the enforcement of intellectual property rights will help in understanding the methods by which protection may be created and maintained as well as the view of the courts in enforcing such protection. This distinction may be readily seen when it is appreciated that in the absence of a covenant-not-to-compete, a third party, including an ex-employee, may create a competing business and may indeed attack, directly or indirectly, the goodwill of the former employer. Diodes, Inc. v. Franzen, 260 Cal. App. 2d 244 (1968). The ex-employee may create a new business which provides better service than the former employer and may vigorously advertise such superior service, thereby eroding the goodwill of the former employer. So long as the ex-employee does not run afoul of other laws defining unfair competition, the new business may compete so strongly as to literally destroy the value of the ex-employer's business. This is perfectly fair competition. And in the absence of a covenant-not-to-compete, there is nothing an employer can do, save competing in the best manner in which it is able. So from one perspective, a covenant-not-to-compete prevents fair competition.

By contrast, when an ex-employee misappropriates trade secrets, which may include customer lists, secret supplier sources, or manufacturing methods and processes, this conduct constitutes unfair competition. To put it another way, even in the absence of any agreement between an employer and employee, if an ex-employee steals a trade secret and uses or discloses such trade secret, the ex-employee may be held to account for damages and may be enjoined under, for example, the Uniform Trade Secrets Act. The point to be understood is that the protection of goodwill is possible only through a contractual relationship between two parties whereas the protection of intellectual property rights of the non-statutory variety are protectable regardless of any contractual relationship between the parties because of the applicability of unfair competition (used in its most generic sense) laws.

All this having been said, it will not be surprising that in the vast majority of the reported cases where a covenant-not-to-compete is in issue, there will be related claims for violation of intellectual property rights. In a common fact pattern, an ex-employee salesperson may steal a list of customers and their requirements immediately preceding termination and then in violation of a written covenant-not-to-compete contract will contact those customers in the course of competing with his ex-employer. The employer will then bring an action for breach of the contract containing the covenant-not-to-compete with a parallel claim for theft of trade secrets. Yet the distinction between covenants-not-to-compete and protection of intellectual property rights is important since quite obviously one of these claims could be defeated (the contract was not validly formed or the customer list was not properly protected as a trade secret) while the parallel claim may provide the necessary relief.

D. Particular Relationships

One further consideration that particularly affects the interpretation and enforcement of covenants-not-to-compete is the nature of the business in which the parties are engaged. One area in which covenants-not-to-compete are frequently used is in the practice of medicine. Getty, M.G., Enforceability of Noncompetition Covenants in Physician Employment Contracts: Confusion in the Courts, 7 J. Legal Med. 235 (1986); Annotation, Validity and Construction of Contractual Restrictions on Right of Medical Practitioners to Practice, Incident to Employment Agreements, 62 A.L.R. 3d 1014 (1975). Clinics or other associations of doctors may require as a condition of employment or becoming a partner or shareholder that the doctor agree not to compete with the clinic in a certain territory for a certain time. At least in one case, Humana Medical Plan, Inc. v. Jacobson, 614 So. 2d 520, 522 (Fla. 3d DCA 1992), the court struck down the restrictive covenant on public policy grounds because of the importance to the public of the doctor-patient relationship. In other words, the freedom of contract consideration was subservient to the public interest in preserving doctor-patient relationships since presumably if a doctor left the clinic and was required to practice

outside of a proscribed geographic area, patients would be deprived of their existing relationship with the doctor. In another Florida case, Damsey v. Mankowitz, 339 So. 2d 282 (Fla. 3d DCA 1976) a covenant which prohibited a surgeon from practicing medicine in a geographic area was struck down on public policy grounds because there was a “compelling need” for surgeon services in that particular geographic area. We have not found any New Mexico cases which have recognized the superiority of the public interest in doctor-clinic covenant-not-to-compete restriction agreements.

Another area where public policy considerations have a unique impact on the use of covenants-not-to-compete is in the legal profession. Generally speaking, it is improper for a law firm to require a member or employee of the firm to sign a non-competition agreement. Model Rules of Professional Conduct (MRPC) Rule 5.6 (1983); Model Code of Professional Responsibility (MCPR) DR 2-108 (1980). The applicable rule in New Mexico is SCRA 16-506 (1986). The rationale is not dissimilar from that which the Florida courts have applied in the above-mentioned medical practice cases. The underlying basis for proscribing lawyer covenants-not-to-compete is that it would deprive the client of ready access to the lawyer of his or her choice and limits the right of the lawyer to practice freely. Of course, the latter consideration is true in every covenant-not-to-compete case. Lawyers who have attempted to evade the rule proscribing covenants-not-to-compete have, for example, drafted clauses in which there were certain financial penalties or disincentives for lawyers who chose to leave and compete with the firm. Generally speaking, these provisions have also been found illegal. Spiegel v. Thomas, Mann & Smith, P.C., 811 S.W.2d 528 (Tenn. 1991) (deferred compensation pay contingent on refraining from practice of law); Hagen v. O’Connell, Goyak & Ball, P.C., 683 P.2d 563 (Ore. Ct. App. 1984) (valuation agreement between corporate shareholders provided that if the departing shareholder refused to sign a non-competition agreement, she must sell her stock at a 40% reduction in price); Anderson v. Aspelmeier Fisch, Power, Warner & Engberg, 461 N.W.2d 598 (Iowa 1990) (with clause that provided that any act detrimental to the partnership which affected its

value could affect the buyout price, a departing shareholder who took clients and opened a competing practice was allowed to do so because the “detriment” provision was void). While there appears to be a *per se* rule against the use of covenants-not-to-compete in the lawyer context, there is much agitation about why a rule of reason does not apply as in other employee relationships particularly comparing the lack of logic in permitting covenants-not-to-compete in the medical field but not the legal field.

Welliver, D.L., When the Walls Come A “Tumblin” Down: A Look at What Happens When Lawyers Sign Non-Competition Agreements and Break Them, 29 Ind. Law. Rev. 729 (1995).

The courts in Colorado have been unequivocal in stating that Colorado law embodies a strong public policy disfavoring covenants-not-to-compete, at least in the area of protecting employees. DBA Enterprises, Inc. v. Findlay, 923 P.2d 298, 302 (Colo.App. 1996); Colorado Accounting Machs., Inc. v. Mergenthaler, 609 P.2d 1125, 1128 (Colo.App. 1980). Indeed, notwithstanding that the Colorado statute, supra, appears in the Labor Code and is specifically directed to the employee-employer relationship, Colorado's distaste for such covenants has resulted in interpretation of that section so as to apply in non-employment contexts. Smith v. Sellers, 747 P.2d 15 (Colo.App. 1987) (independent contractors); Gold Messenger, Inc. v. McGuay, 937 P.2d 907 (Colo.App. 1997) (franchisor-franchisee relationship).

II. COVENANTS-NOT-TO-COMPETE

A. Introduction

The covenant-not-to-compete, as indicated above, may arise in the employer-employee context or in the documents accompanying the sales of a complete business. In the latter case, the covenant may be incorporated into a consulting contract which is frequently given to the key employee/owner of the business being sold. It may however also appear as a free-standing document. In the case of the

employer-employee relationship, the covenant-not-to-compete is frequently included as one provision of an employment contract. However, where a covenant was not entered into at the time of the employment, or during employment, the parties may agree to a covenant as part of a termination package. For example, former employees with particularly valuable and unique skills to the business who are not intending to compete directly with their former employer, may enter into a consulting arrangement for a period of time and the covenant may be included in the consulting contract.

B. The Basic Elements

As will be apparent from the description of the typical implementation of a covenant-not-to-compete, one required element is that there be consideration in exchange for the covenant. This is of course simple contract law. The additional elements are unique, however, to covenants-not-to-compete. While the courts state these requirements in various ways, they may be paraphrased as: 1) the covenant protects an employer's legitimate business interest; 2) the covenant is reasonable in time, space and subject matter; and 3) the covenant is not violative of the public interest.

Manuel Lujan Insurance, Inc. v. Jordan, 100 N.M. 573, 673 P.2d 1306 (1983), involved an employment contract with a restriction on post employment competition. The defendant had joined the plaintiff employer as a manager and worked there for two years. The parties had entered into an employment contract drafted by the employer which provided:

In event [sic] the employee shall leave the employment of the Company, or if his employment is terminated by the company for any reason or cause whatsoever, he shall not for a period of two (2) years from the date of termination of employment solicit the customers (policyholders) of the company, either directly or indirectly. The purpose of this paragraph is to ensure that the employee for the period set out herein, will not in any manner

directly or indirectly enter into competition with the company on [sic] the customers of the company as of date of termination.

Id. at 575.

In addition to the contract, the employee was required to notify all businesses with which he dealt while employed that he represented the employer and no other business. Moreover, all records and similar materials concerning business transactions were to remain in the undisputed control and possession of the employer.

The ex-employee's argument after having transacted business with several customers of his previous employer was that the restrictive covenant precluded solicitation, but not the acceptance of business from the employer's customers if that business was not solicited. Plaintiff relied on several non-New Mexico cases and the court agreed that the language of the contract was ambiguous as to whether it simply barred solicitation of customers, or barred doing business with such customers regardless of how the business originated.

The court concluded that based on parol evidence, the restrictions should be construed as preventing the ex-employee from doing business with any customer of his former employer, regardless of how that business was generated. The court relied upon parol evidence that had been admitted at trial, the most important of which was that the employee had during negotiation of the contract requested that he be permitted to do business with the employer's customers after employment, and that in the post-termination phase, he twice requested of his ex-employer that he be permitted to purchase the business of several past customers.

The case provides a caution for properly drafting a restrictive covenant against post-termination competition so as to carefully define that the covenant relates not merely to solicitation, but also to transacting business even if the customer approaches the ex-employee. There was no discussion by the court that going beyond a prohibition against solicitation in any way violated public policy.

C. Consideration

The most common problem in the area of consideration arises when a covenant is negotiated during the course of employment. If the covenant is entered into at the time the employment began, then the employment itself is commonly used and will be readily accepted by courts as the consideration offered in exchange for the covenant. And as noted above, one possible situation in which the covenant may be implemented is at the termination of employment, where clearly consideration is required and is often given in the context of a consulting arrangement whereby payments are made to the ex-employee/consultant.

The most difficult area from the point of view of the adequacy of consideration is when the covenant-not-to-compete is implemented during the course of employment. While no specific case law has been found in the State of New Mexico, at least some courts have held that the mere continued employment is in itself adequate consideration for the covenant. Goodyear Tire & Rubber Co. v. Miller, 22 F.2d 353 (9th Cir. 1927). However, relying upon continued employment as consideration is risky. The safer course is to provide some additional consideration to the continued employment such as an outright payment, bonus, salary increase, some non-monetary benefits such as stock options, restrictive stock, deferred compensation, a new title, increased responsibility, or other benefits. Chenault v. Otis Eng'g. Corp., 423 S.W.2d 377 (Tex. Ct. App. 1967). Of course, if the employment is not at will, i.e., the employment is for a term as defined in a written agreement, then continued employment will totally fail as adequate consideration for a later negotiated covenant-not-to-compete.

Although not explicit in the case law relating to covenants-not-to-compete, there appears to be a judicial tendency to find that consideration is lacking if the term of employment has been extremely short. To state the obvious, if an employee is hired and executes a covenant-not-to-compete upon commencement of the employment but is fired within three days, it is not likely that the court will find that there is adequate consideration. The rationale is less based on the lack of value of the consideration than that the public policy basis for exempting covenants-not-to-compete from normal

prohibitions on restraints on trade fail, because it is so unlikely that the short-time ex-employee should not be allowed to improperly capture the employer's goodwill. See, generally, Anno., Sufficiency of Consideration for Employee's Covenant Not to Compete Entered Into After Inception of Employment, 51 ALR 3d 825 (1973).

D. Scope, Time and Subject Matter

As a general proposition, the law is well settled that covenants-not-to-compete must be limited in scope to what is reasonable under the circumstances of the relationship. This is generally interpreted as meaning that the geographic scope must be circumscribed, that the time must be limited, and that the subject matter must be restricted. Sprague's Aetna Trailer Sales, Inc. v. Hruz, 474 P.2d 216, 217-18 (Colo. 1970); Riverdell Forest Prods. Ltd. v. Georgia-Pacific Corp., 824 F.Supp. 961, 969 (D. Colo. 1993).

1. Geographic

It is apparent that the permissible geographic scope of a covenant will be highly dependent upon the nature of the business. Certainly the geographic area in which the employer has an established reputation and from which the employer draws most of its customers will define a geographic scope that is reasonable. For example, in a retail business, a covenant that is reasonable in scope would almost assuredly be sustained if it is limited to the city in which the business is located, very probably the county in which it is located, and possibly the entire state. It should be borne in mind that the basis for sustaining covenants-not-to-compete is that the ex-employee, without the covenant, would be in a position to unfairly capture the goodwill of the employer. So, the geographic scope should be commensurate with the territory in which the goodwill exists. That generally means that one can look at the customer base of the employer and, excluding the occasional out-of-town customer, the customer base defines the limits of the goodwill.

One of the most difficult problems in the area of defining the geographic scope is the company that does business nationally or internationally or on the Internet.

If the business is highly specialized, i.e., has a narrow, but deep line of products or services, the business may be relatively small yet it may have established customers throughout the world. If an ex-employee who has relations with customers, suppliers, or others on which the goodwill of the business is based joins a competitor in the same narrow line of commerce, then a convincing argument may be made that the scope of the geographic covenant could be the entire world. Multinational businesses may have a worldwide extensive goodwill although it does not necessarily follow that an ex-employee working for one of the business units of such multinational company will automatically be prohibited from competing throughout the world in a written covenant-not-to-compete.

While stating that the geographic scope is dependent upon the particular facts of each case is not particularly helpful, it certainly suggests that in drafting or litigating a covenant-not-to-compete, analogous businesses should be looked to determine what would be the proper scope of a geographic restriction.

2. Time

Much the same can be said for the amount of time. It is commonly stated that a covenant which extends for a one-year period of time will almost invariably be accepted by a court. Two years is generally acceptable. But there are cases in which five years have been found to be permissible. It is our opinion that two years is a good rule of thumb from which the particular circumstances of the case can be used to add or subtract a bit of time. The covenant protects the employer's goodwill. After a sufficient period of time the ability of the ex-employee to use personal relationships established by working for the employer to capture some of the former employer's goodwill will dissipate. Moreover, while the case law does not specifically reflect the interplay between geographic scope and time, clearly the more narrow the geographic scope the more permissible a longer period of time and vice-a-versa.

3. Subject Matter

The third element of the restrictions which must be reasonable relates to the definition of the business. For example, in the case of a retail dry cleaning establishment, a covenant-not-to-compete will be readily interpreted to prevent an ex-employee from offering retail dry cleaning services. Whether or not that may include retail laundry services may not be clear. It would be better to define that in the written covenant-not-to-compete itself. But other problems may arise. The ex-employee may wish to engage in the offering of dry cleaning service solely to retail establishments. In our opinion that would fall outside of the scope of the subject matter because the customer base and the employer's goodwill does not extend into that business activity. The problem becomes more complex when a business has multiple subsidiaries, divisions, or business units. A good rule of thumb is that the type of business should be restricted to the business activities of the particular business unit. However, exceptions may arise in which the scope of the subject matter may be somewhat broadened.

E. Employer's Legitimate Business Interest

Although the courts often make reference to the fact that the covenant-not-to-compete must serve a legitimate purpose of the employer, it does not appear that cases ordinarily turn on the existence or non-existence of this particular element of the restriction. However, certain courts have been explicit in requiring that a covenant protect the enjoyment of a legitimate benefit by the promisor. Ohio Valley Communications, Inc. v. Greenwell, 555 N.E.2d 525, 528 (Ind. Ct. App. 1990) (a "covenant will be enforced if it is reasonable, is ancillary to the main purpose of the lawful contract, and is necessary to protect the covenantee in the enjoyment of the legitimate benefits of a contract or to protect the covenantee from the dangers of unjust use of those benefits by the covenantor."); Pollack v. Calimag, 458 N.W.2d 591, 598 (Wis. Ct. App. 1990), review denied, 461 N.W.2d 444 (Wis. 1990) (A valid covenant must "(1) be necessary for the protection of the employer or principal; (2) provide a reasonable time restriction; (3) provide a reasonable territorial limit; (4) not be harsh or oppressive to the employee; and (5) not be contrary to public policy."). In the

RESTATEMENT (SECOND) OF CONTRACTS, § 188, Cmts. d, g (1979), it is stated that there are three basic interests that are protectable: (1) the customer relationship or "good will"; (2) trade secrets or other confidential information; or (3) in the context of employment relationships, unique attributes or skills possessed by an employee.

Of course, anything that is outside of the reasonable scope of the geographic area, time or subject matter could be construed as an area in which the employer does not have a legitimate business interest and the court may so phrase its reason for striking down or "blue penciling"² the covenant. It is also true that the employee-plaintiff may make a strong case for the lack of effect on goodwill to the success of the business. For example, it could be argued that a catalog business where employees have little or no personal contact with a customer has less goodwill than a retail establishment such as a barber shop or a hair salon. On the other hand, catalog companies oftentimes build goodwill through the process of delivery, amenability to returns, and general strong customer service. Nevertheless, if the ex-employee enters into a catalog business which offers the same type of competitive differentiation factors, the ex-employee may not be exploiting anything but broad business policies that lead to success rather than to depriving the former employer of the personal goodwill that may have been built in a retail environment. Again, each case turns on specific facts. However, examining the legitimacy of the employer's interest in enforcing a restrictive covenant is generally reflected by defining the reasonableness of the scope of the restriction.

F. Public Interest

The public interest is always a consideration in covenants-not-to-compete. Many courts fasten on one aspect of the public interest -- the necessity of the ex-

² To "blue pencil" a covenant is to construe it in a manner most likely to preserve its validity. Some courts use "blue penciling" only where the unlawful provision is "grammatically severable". Oliver/Pilcher Insur., Inc. v. Daniels, 148 Ariz. 530, 532-33, 715 P.2d 1218, 1220-21 (1986). Others are not so demanding.

employee to earn a living. As noted above, there is clearly a more liberal attitude toward enforcing covenants-not-to-compete that are implemented as part of the sale of the business, as opposed to the employer-employee context. One reason is that the employer-employee relationship generally reflects a superior bargaining position in the employer. Another reason is the solicitude for an employee who should not be prevented from working on the basis of simple fairness and justice, but also because to do so deprives the public of the value of the employee's services and contributions to the welfare of society. Josten's Inc. v. Cuquet, 383 F.Supp. 295, 299 (E.D. Mo. 1974) ("a form of industrial [peonage@](#)).

It can be generally stated that the more highly specialized the position held by the employee, the more difficult it may be for the employee to find similar employment within the same geographic scope and subject matter of the restriction. A retail clerk in a dry cleaning establishment develops skills that are intrinsic to the particular service being offered but by and large the skills are those of retail selling which may be generally applicable to a wide variety of retail sales position. On the other hand, a mechanic that specializes in repairing foreign made diesel engines for trucks may have few opportunities to use these skills unless he/she can be employed working on the same type of engine made by the same manufacturer. The arguments in this latter hypothetical are readily anticipated. The employee may argue that his highly developed skills will command only the same remuneration in the marketplace if he works on the same type of engine manufactured by the same company. To accept a job working on other diesel engines made by other manufacturers make his/her skills less valuable to a prospective employer. On the other hand, the employer may argue that diesel skills are diesel skills. Not only should the employee be restricted from working on diesel engines from the same manufacturer, but should be restricted from working on diesel engines for trucks in general. The employer may argue that the ex-employee could work on diesel engines for automobiles or locomotives. The employer could argue further that diesel engines are not so different from standard internal

combustion engines that the employee may not find comparable gainful employment working on any type of truck engine. Thus it will be seen that there will be arguments to be made as to whether an ex-employee is being restricted from his/her “livelihood” and indeed what does “livelihood” mean -- a job with the exact same compensation or a job with substantially the same compensation? Modern Controls, Inc. v. Andreadakis, 578 F.2d 1264 (8th Cir. 1978).

The other aspect where public interest may come into play was discussed above with respect to particular employer-employee relationships such as in the medical or legal field. See also, Republic Aviation Corp. v. Schenk, 152 USPQ 830 (NY Sup. Ct. 1967).

G. Litigation of Covenants-Not-to-Compete

1. Background

Litigation involving covenants-not-to-compete is almost always, though not exclusively, brought to obtain injunctive relief. That is not to say that damages may not be available. Covenant-not-to-compete lawsuits also invariably involve an attempt to obtain a preliminary injunction, and rarely, a temporary restraining order. The ex-employee may often be joined as a defendant with the new business or competitor whom the ex-employee now works for particularly if, in addition to a breach of a covenant-not-to-compete, there is also theft of intellectual property rights. In any event, the ex-employee may raise certain equitable defenses that are generally available in contract actions. And it is also expected that the ex-employee may raise certain counterclaims.

2. Injunctive Relief

By far the most common relief sought in the enforcement of a covenant-not-to-compete is injunctive relief.

It is not merely permanent injunctive relief that is typically sought, but a preliminary injunction is almost always pursued. This follows from the simple nature of a breach of the covenant which causes damages to goodwill which, by and large, is

extremely difficult to measure. In many instances, unless relief is immediately sought, the ex-employee starting a new business may gain a foothold in the market which cannot later, after prolonged litigation, be recovered. Thus, speed is the very essence of obtaining meaningful relief for breach of a covenant-not-to-compete.

The law in New Mexico with respect to obtaining a preliminary injunction does not differ from that in most states. The test is usually stated as including four factors: 1) irreparable harm if the injunction is denied; 2) the hardship that will be suffered by the ex-employee if the injunction is granted; 3) the interests of the public; and 4) the likelihood of success on the merits. These factors must be met even if the contract is drawn so that it expressly states that breach of a covenant-not-to-compete will entitle the employer to injunctive relief. The courts will still scrutinize the facts to determine whether the four elements weigh in favor of an injunction just as if the contractually mandated injunction provision was not present.

Irreparable harm in many cases will be deemed to exist if there is a strong likelihood of success on the merits. In other words, the first factor may be proved by a strong showing of the existence of the fourth factor. This is generally true in intellectual property enforcement actions where a preliminary injunction is sought and is invariably true in trade secret or covenant-not-to-compete litigation. In any event, the employer is typically able to prove for the reasons stated above, that damages are an inadequate remedy and that continued breach of the covenant whether the ex-employee has started a new business, or has joined a competitor of the former employer, will irreparably injure the goodwill of the former employer.

The solicitude for the right of the employee to seek gainful employment is generally reflected in the court's consideration of the second factor. If the result of the injunction is to literally prevent the employee from obtaining employment, then this factor will weigh heavily against the grant of injunctive relief. On the other hand, if the restriction is reasonably limited in scope, the employer stands a much better chance of showing that issuance of the injunction will not deny the employee the right to earn a

living. As far as the third factor -- the public interest -- the court will be weighing the same factors as set forth in the introduction to this paper.

From a procedural point of view, it is common in seeking a preliminary injunction in a covenant-not-to-compete case for one of the parties to apply to the court to consolidate the trial on the merits with the preliminary injunction hearing. In the federal courts, provision for such consolidation is found in Fed. R. Civ. P. 65(a)(2). Consolidation must be carefully considered. In the first place, the ex-employee defendant may elect to have the matter tried before a jury, counting on the sympathies toward the underdog; but an agreement to consolidate will waive this right. Second, there is a tactical element in the request for consolidation since the court is more likely to provide more extended discovery time to the defendant (who will likely be less prepared) if the matter is to be heard on the merits.

The former employer may also seek to obtain a temporary restraining order under Fed. R. Civ. P. 65(b). In addition to the standard showing for a preliminary injunction, it must be shown that there is "immediate and irreparable injury" and an attempt was made to give notice to the defendant to no avail. Note also that Rule 65(b) permits a temporary restraining order to exist for only ten days, without extension by the court, and thus it is common to obtain an order to show cause from the court as to why a preliminary injunction should not be issued at a hearing at the end of the ten-day period.

One important procedural point not to overlook is that Fed. R. Civ. P. 65(c) requires (there is no discretion in the court) that security be given upon issuance of a preliminary injunction.

One additional point of advice is that in seeking a preliminary injunction the relief requested should be very carefully defined, as required by Rule 65. It should also be carefully tailored so as not to overreach as to the scope. Where the relief is overly broad, the appellate court may overturn the injunction with a remand to the lower

court to fashion an injunction more limited in scope. Excelsior Laundry Co. v. Diehl, 32 N.M. 163, 252 P. 991 (1927).

3. Damages

Monetary recovery is appropriate for the actual loss of profit sustained by the employer or gained by the ex-employee. See, Central Security Alarm, infra, Section H.1. for similar measures in a breach of loyalty case.

4. Defenses

Since enforcing a covenant-not-to-compete is essentially a contract action, all of the available equitable defenses may be raised. The defense of laches is a very effective defense where the employer has simply dawdled in seeking relief, generally waiting to see whether or not the ex-employee's new business will be successful.

A standard defense that is usually tendered is that the employee was terminated which constituted a breach of the employment agreement and therefore vitiates the right of the employer to seek enforcement of the covenant-not-to-compete. That defense will not often lead to success. On the other hand, a wrongful discharge will relieve the former employee of any obligation under a non-competition agreement. Rao v. Rao, 718 F.2d 219 (7th Cir. 1983) ("the exercise of a good faith termination is a condition precedent to the operation of the restrictive covenant"); McCormick v. Empire Accounts Service, Inc., 49 Ill. App. 3d 415, 364 N.E.2d 420 (Ill. App. 1977) (wrongful discharge of senior executives which made a restrictive covenant unenforceable); but see Gomez v. Chua Medical Corp., 510 N.E.2d 191 (Ind. Ct. App. 1987) (dismissal of at-will physician for other than good cause does not render unenforceable otherwise reasonable covenant restricting competition).

There remain the standard contract defenses; e.g. lack of consideration, mutual mistake, unilateral mistake, statute of limitations, etc. It also appears that an oral non-compete agreement of unlimited duration may lie outside the statute of frauds. Metcalf Investments, Inc. v. Garrison, 1996 W.L. 380285 (Alaska, June 28, 1996).

One interesting issue that may arise in the covenant-not-to-compete fact pattern is the position by some practitioners that a covenant-not-to-compete should include a liquidated damages clause. See Appendix F, Sample Agreement, ¶ 7.3. Assuming that the clause meets the general standard of validity, i.e., that at the time the contract was entered into, damage for breach was not readily ascertainable and the liquidated damages are not a penalty, courts have recognized that they may be valid as a form of relief for breach of the covenant. See, e.g., Salamon v. Munuswamy, 566 So. 2d 899 (Fla. 4th DCA 1990) (contract provided for \$150,000 in liquidated damages which the ex-employee elected not to pay and challenged the employer's attempt to obtain injunctive relief). As for the obvious question, whether the presence of a liquidated damage clause will prevent injunctive relief (since by its very nature it declares that the parties have agreed that the amount of monetary damages specified are adequate), courts have held that it does not prevent the injunctive relief. Beery v. Plastridge Agency, Inc., 142 So. 2d 332 (Fla. 2d DCA 1962).

5. Counterclaims

Almost invariably, the employer seeking to enforce a covenant-not-to-compete should expect that the employee will bring an action for interference with contractual relations. See the discussion below with respect to alternative relief to covenants-not-to-compete.

H. Alternative Non-Contract Protection

1. Duty of Loyalty

The Restatement (Second) of Agency §§ 387-398 (1958) sets forth a variety of duties of loyalty from an agent to a principal and from a servant to a master. The general principle is set forth in § 387 as: “Unless otherwise agreed, an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency.” The scope of this duty encompasses an obligation of the agent not to take “. . . unfair advantage of his position in the use of information or things acquired by him because of his position as agent or because of the opportunities which

his position affords.” § 387, comment b. On the other hand, the agent is not necessarily prevented from acting in good faith outside of his employment even if such actions may injuriously affect the principal's business.

Central Security and Alarm Co., Inc. v. Mehler, 121 N.M. 840, 918 P.2d 1340 (1996), involved an action by an employer against a salesman who had been working for the employer for more than 15 years. During his employment, after obtaining two large accounts, defendant formed a separate corporation in which he owned fifty percent of the common stock and then diverted the business of one of the two large customers to the competitor that he had created and owned. Central sued for breach of the duty of loyalty as well as intentional interference with contract relations. The jury found in Central's favor on the former claim, and against it on the latter. The court affirmed, holding that an employee has a duty of loyalty to the employer. Citing the RESTATEMENT OF AGENCY, the court held that unless otherwise agreed, an employee may not compete with his employer.

The primary focus of this case was upon the appropriate measure of damages. The court noted that the employer's potential remedies for a violation of the duty of loyalty included an action for losses as well as an action for restitution which would include a constructive trust or accounting for profits. Under the former remedy, the employer may recover compensatory and punitive damages. Salter, 105 N.M. at 712. Restitution, of course, measures the defendant's gain or benefit. The court noted that the plaintiff may pursue both theories and if liability is found on each, it would then be required to make an election.

Under § 388, the agent's duty of loyalty includes the duty to give profits to the principal if such profits were made in connection with transactions conducted by him on behalf of the principal. Presumably, this duty encompasses the accretion of value on profits diverted by the agent from his principal. Whether or not the agent has a right to a gratuity depends on whether it is a custom of the business for the agent to retain such gratuities.

Section 393 specifically relates to competition between an agent and a principal: “Unless otherwise agreed, an agent is subject to a duty not to compete with the principal concerning the subject matter of his agency.” The principal’s interests are always to be preferred to the agent’s if the circumstances are such that the agent is permitted to operate a competing business but an opportunity arises which may advance the principal’s interests. It is entirely irrelevant whether the agent is using the principal’s facilities or equipment.

Section 393, comment e, treats the question of whether an agent may prepare for competition either before or after termination of the agency. During the agency, the agent may make arrangements to compete but may not use any confidential information peculiar to the employer’s business and acquired through the agency relationship. For example, an agent, such as an employee, while still employed, could purchase a competing business immediately prior to termination and then terminate employment and operate the competing business immediately. However, should the agent solicit customers for the business to be acquired while still employed, there would be a breach of the duty of loyalty. Similarly, during the employment, an employee may not cause or induce fellow employees to terminate their relationship with the employer and to join the employee in a new competing business. If several top managers of a company agree to leave their employment simultaneously and without giving any notice to their employer, in order to enter into a competing business, there is a breach of duty for which they may be held liable.

Las Luminarias of the NM Council v. Isengard, 92 N.M. 297, 587 P.2d 444 (Ct. App. 1978), involved a claim by a non-profit organization against ex-employees for breach of the duty of loyalty. During the time in which the employees worked for the non-profit organization, they had formed a separate non-profit corporation to compete for the same government contracts. Moreover, they made it known to the government entity that if the contracts were awarded to their then employer, they would resign thus depriving the government entity of their services, but if the contract was awarded to the

newly formed corporation, they would resign and join that new corporation. There was no employment contract or other written agreement between plaintiff and the defendants. The court held that it was well settled that the employment relationship is one of trust and confidence and places upon the employee a duty to use his best efforts on behalf of his employer. The court relied upon numerous foreign jurisdiction cases as well as Restatement (Second) of Agency § 287 (1958). The court affirmed that the general rule was that when one undertakes to act for another in any matter of trust or confidence, he shall not in the same matter act for himself against the interests of the one relying upon his integrity. The court adopted the established rule that demands of a corporate officer or employee an undivided and unselfish loyalty to the corporation.

However, the Court noted that there was an exception to this duty of loyalty where the employees are forming a competing organization. The court held that an employee does not violate his duty of loyalty when he “merely organizes a corporation during his employment to carry on a rival business after the expiration of his term of employment.” *Id.* at 302. That exception however is limited to the planning of a competitor by an employee while still employed but does not permit the employee to engage in “disloyal acts in anticipation of future competition”. *Id.* at 302. Accordingly, “. . . an employee may not use confidential information peculiar to his employer’s business and acquired through the course of employment.” Restatement (Second) of Agency § 393, comment e (1958). The court further held that “. . . an employee may not solicit customers before the end of his employment or do other similar acts in direct competition with the employer’s business.” *Id.* The court then distinguished the cases relied upon by defendants which purportedly held that an employee may compete with his employer if he does so in good faith. The court pointed out that other authorities draw a distinction between planning or making arrangements to compete which is permissible, and engaging in actual competition. Even as to the cases relied upon by defendants, the court held that because defendants had used the records and papers of

their employer to prepare a competitive proposal, their conduct was in bad faith and constituted a breach of their duty of loyalty to their employer.

In the post-termination period there is, absent any restrictive covenant-not-to-compete, no duty of the ex-employee or ex-agent not to compete. However, the Restatement, § 396, makes it clear that the obligation not to use confidential information is different from the obligation not to compete. Even absent a non-disclosure agreement, this section of the Restatement makes it clear that a principal may pursue an ex-employee that uses trade secrets or other confidential business information (discussed infra), because to do so would be a violation of the duty of loyalty. Assuming that there is no breach of confidential information or theft of trade secrets, the duty of loyalty will not prevent an ex-employee from soliciting former employees after terminating employment. Despite the provision of the Restatement, there are cases holding that such post-termination solicitation of fellow employees may be unlawful, but those cases typically involve the use of confidential information and/or trade secrets and thus it is not clear that post-termination solicitation alone would constitute a breach of loyalty.

Assuming that there is no restrictive covenant or independent covenant-not-to-compete, an employer may rely upon the duty of loyalty to establish that the competing activity of the ex-employee is unlawful, particularly if it involves the diversion of business, appropriation of business opportunities, or commencement of competing activities while still in the employ of the principal.

2. Intentional Interference with Existing or Prospective Contractual Relations

The Restatement (Second) of Torts § 766 (1979) recognizes several torts which may occur in the context of competition between an employer and an employee (or other principal and agent) through the intentional interference of the relationship of the other party with third parties. One who intentionally and improperly interferes with the performance of a contract between one person and a third person by

inducing either of them not to perform the contract may be subject to liability for the pecuniary loss resulting from the failure of the third person to perform the contract. Id. Section 766 deals specifically with interference with an existing contract. It may come into play, for example, in the above-discussed fact pattern where an ex-employee attempts to induce fellow employees to terminate their employment relationship with the ex-employer. Notwithstanding that such employees may likely have contracts that are terminable at will, there is still at the time of the inducement an existing contract and the breach of that contract, such as by convincing the fellow employee to terminate employment and join the ex-employee will give rise to liability. Establishing this tort requires that the person accused of interfering is aware of the existence of a contract and has the intent to interfere, even if such interference is incidental to the actor's independent purpose so long as that interference is a necessary consequence of his action. Section 766, comment j.

In addition to the co-employee wrong, § 766 also appears to give a cause of action to an employer if an ex-employee induces customers who have existing contracts (long-term purchase agreements) or supply contracts (materials requirements contracts) to discontinue the relationship with the ex-employer. Thus, it is important to look at all of the activities of the ex-employee with respect to the various relationships established by the employer with third-parties in various capacities. This could include, for example, banking relationships, government franchises or licenses, etc.

This cause of action may be available to the ex-employee as well. For example, if ex-employees form a new corporation and obtain financing from a source such as a venture capitalist, threats or inducements to the venture capitalist by the employer may constitute an improper interference with an existing contract.

Section 766B goes beyond the creation of liability for interference with existing contracts and provides a cause of action for interference with prospective contractual relations. The typical fact pattern in the terminated employment fact pattern involves the attempt by ex-employees to obtain business by pursuing a customer of

their ex-employer. In this situation, it is likely that the ex-employees' actions may be additionally in violation of a confidential business relationship established between the employees and ex-employer. And the role of the parties may be reversed, as suggested above, if the former employer learns that the ex-employees form a company and are pursuing a business opportunity where the former employer interferes with the new company's attempts to secure the business. It is apparent that in many of these competing ex-employee fact patterns, both parties may claim that the other is liable for an intentional interference with a prospective customer relationship.

The elements of this cause of action include knowledge by the interfering party that a prospective business advantage is being pursued, an intent to interfere, and some overt acts which demonstrate the inducement or causing of the failure of the prospective relationship to occur. Note also that in these fact patterns, there may be additional causes of action because the means of interference may involve defamation, injurious falsehood, fraud, violence, threats, or similarly independently actionable conduct.

3. Conversion (Misappropriation of Personal Property)

Still another possibility for pursuing an ex-employee would be based on the misappropriation of personal property of the employer's property rights. At least arguably, such property right could include the employer's goodwill, which has been recognized as a species of personal property.

4. Unfair Competition

New Mexico has enacted the Uniform Deceptive Trade Practices Act (UPA), NMSA §§ 57-12-1, et seq. (Appendix C). The UPA recognizes a wide variety of unfair competitive acts which generally comprise false or misleading oral or written representations, knowingly made, which may tend to, or do, deceive or mislead any person. Of particular interest are the examples of "unfair or deceptive trade practices" in § 57-12-2 which includes statements that cause confusion or misunderstanding as to source, sponsorship or approval of goods or services, or which cause confusion or

misunderstanding as to affiliation, connection or association with another. An unscrupulous ex-employee may attempt to obtain business by trading on existing personal relationships where the third party is led to believe that the new organization is in some manner affiliated with the ex-employer. Excelsior Laundry Co. v. Diehl, 32 N.M. 163, 252 P. 991 (1927). In another specific example of an unfair deceptive trade practice act, the UPA proscribes “disparaging the goods, services, or business of another by false or misleading representations”.

While the UPA does not specifically address situations in which competitors previously had an existing relationship (employer - employee, seller - buyer, etc.) these torts are likely to occur in the ex-employee competition with a former employer. As noted above, the causes of action may be available to either of the parties to the relationship.

III. INTELLECTUAL PROPERTY RIGHTS ENFORCEMENT

A. Introduction

As noted above, in addition to protecting its intangible assets through a covenant-not-to-compete, an employer may also enter into an agreement with an employee relating specifically to non-statutory intellectual property rights. With the technical, scientist or engineering employee, the typical agreement will be an invention assignment agreement that is combined with a non-disclosure agreement. The invention assignment agreement controls rights to inventions which the employee creates during the employment period, generally requiring the employee to assign any patent applications and maturing patents based on the invention to the employer. It may be noted that, even in the absence of an invention assignment agreement, under common law, if the employee is permitted to own the invention, the employer is generally granted a license referred to as a “shop right” to use the invention during the life of the patent. U.S. v. Dubilier Condenser Corp., 289 U.S. 178, 188 (1933).

Aside from the technical/scientific employee, agreements with management employees and often with salespersons may be drafted as a straight non-disclosure agreement or, in some business contexts, a non-solicitation agreement. The latter is typically used with salespersons and specifically prevents them from soliciting customers of the employer. The distinction between a non-solicitation agreement and a covenant-not-to-compete is at best misty. The enforcement of a covenant-not-to-compete may be, and often is, directed against an ex-employee who is soliciting customers of the former employer. In that fact pattern, the difference between the two types of agreements is vague, if not impossible to discern. It follows that in a non-solicitation agreement with a salesperson, it would be well to draft the agreement with the same limitations on restrictions as would be required for a valid covenant-not-to-compete.

The case of Excelsior Laundry Co. v. Diehl, 32 N.M. 163, 252 P. 991 (1927), is one of the earliest cases found in New Mexico addressing the problem of the right of an ex-employee to compete with a former employer. The case involved a “route salesman” for a laundry company who maintained a list of customers, “the particular kind and class of work supplied, and the day and hour of the week when it was to be called for”. Id. at 170. It was admitted that this list of customers was communicated only to those who had a need to know and that the plaintiff employer treated the list as a valuable asset of the business. There was no written agreement between the employee and employer. The lower court had granted an injunction that proscribed the employee from soliciting or doing business with customers that he had acquired while with his former employer. The upper court reversed and remanded because the injunction was too broad in scope. The court noted that one type of conduct of the ex-employee would have been properly proscribable, the facts having been set forth in the lower court’s finding that the employee, after leaving his former employer, visited the same customers, at a time slightly before the time in which he ordinarily called on those customers in accordance with the customer list while still employed with the former

employer, and without informing the customer that he had a new employer, or that he had ceased working for the old employer, took the business.

Nevertheless, the court found that the employee, except for the above-noted conduct, could not be restrained from calling on former customers. The court noted that there was no contract between the plaintiff and defendant. The analysis was typical of a trade secret case. The case demonstrates that the same balancing of employer, employee, and public interest is involved:

It seems to be well settled that, independent of contract, an employer may maintain a bill of equity to restrain an employee from practicing or divulging to others trade secrets, knowledge of which was acquired by him through his employment. It is also said that while equity should lend its aid to the fullest extent to protect the property rights of employers, whether existing in the form of trade secrets or otherwise, consideration of public policy and justice demands that such protection should not be carried to the extent of restricting the earnings capacity of individuals on the one side, while tending to create or foster monopolies of industry on the other.

Id. at 173. The court analyzed a number of earlier cases, many of which dealt with route salesmen. It expressly distinguished any cases in which there was a contract between the employer and employee. It then engaged in a typical customer list analysis, making a distinction between names carried away by memory and those which were written and then taken.

The Excelsior case is most noteworthy for the very limited protection that exists in the State of New Mexico for customer lists, absent an express covenant-not-to-compete.

After the results in the Excelsior case, a good New Mexico lawyer properly advised another laundry company operating in Las Vegas to enter into an employment contract with its route salesman. The contract provided that the employee:

Will not at any time while employed by plaintiff, nor within one year after the termination of such employment, regardless of the

time or cause of such termination, either for himself or for any other person, firm or corporation, other than his employer, or his successors, directly or indirectly, solicit, call for or deliver articles to be cleaned, pressed, dyed or laundered, in the city or town of Las Vegas, or in any other territory in which the employee shall have served the employer under this contract, or any extension of this contract; and that within the aforementioned period of time, he, the employee, will in no manner attempt to induce any of the patrons or customers of the employer, his successors or assigns, to withdraw their patronage or custom.

Id. at 298. The contract includes all of the required elements of a covenant-not-to-compete: 1) consideration (the contract was entered into prior to employment); 2) an appropriate time (one year); 3) geographical scope (Las Vegas or any territory in which the employee worked); and 4) limited subject matter (cleaning, pressing, dyeing, and laundering).

The primary basis of the appeal was that the agreement was void as a restraint of trade and therefore should not be enforced. The court noted:

It is of course a well established rule that a naked agreement by one party not to engage in business in competition with another party is in contravention of public policy and therefore void, unless such agreement and restriction be incidental to some general or principal transaction. That is, its main object must not be to stifle competition.

Id. at 299. The court quoted the earlier case of Tolman Laundry, Inc. v. Walker, 171 Md. 7, 187 A. 836, 838 where it was stated:

The principle is firmly established that contracts only in partial restraint of any particular trade or employment, if found that upon a sufficient consideration, are valid and enforceable, if the restraint be confined within limits, which are no larger and wider than the protection of the party with whom the contract is made may reasonably require.

The court stated that the above quote from Tolman was “universally recognized as the rule,” citing Excelsior Laundry Co. Moreover, the court stated:

We have held in a number of cases that an agreement to refrain from engaging in a certain business or profession within reasonable limits of time and place is valid if subsidiary to other legitimate purposes such as the sale or disposal of property, business or goodwill. Thomas v. Gavin, 15 N.M. 660, 110 P. 841; Gallup Electric Light Co. v. Pacific Improvement Co., 16 N.M. 86, 113 P. 848; Gross, Kelly & Co. v. Bebo, *supra*; Gonzales v. Reynolds, 34 N.M. 35, 275 P. 922.

The court found that the agreement was valid and enforceable. Moreover, the court upheld the lower court's award of damages based on the profit on business lost.

In general, it is believed that the courts are more liberal toward enforcement of a non-solicitation agreement simply because it will rarely prohibit the employee from being deprived of a means of livelihood. In that sense, the non-solicitation agreement may be preferable. On the other hand, recognize that a covenant-not-to-compete may prevent the ex-employee from establishing a separate business or working for a competitor even where the ex-employee does not solicit former customers. A covenant-not-to-compete is thus much broader in scope and may provide protection for a type of conduct that would not be proscribed by the typical non-solicitation agreement.

The non-solicitation agreement may also be combined with the non-disclosure agreement which is often found in management employment contracts. The prohibition against non-solicitation in such contracts, however, is entirely distinct from that used in conjunction with a salesperson. Here, the management employee is typically proscribed from soliciting employees of the former employer to terminate their employment relationship and to join the ex-employee's new entity. In the absence of such covenant, it is well established that an ex-employee may solicit former employees of the employer if it is at least done with modesty. The so-called "employee raid" may well go beyond fair competition and may be attacked either on the grounds that it

constitutes unfair competition under common law, or constitutes an unlawful interference with existing contractual relationships.

While the non-solicitation and technical employee agreements are not out of the ordinary, clearly the most common type of agreement between employers and employees in general is the non-disclosure agreement. The typical format of this agreement is to define the subject matter that the employer considers to be a trade secret (note the definition of trade secret in footnote 1). The agreement then provides that during employment, as well as after termination of employment, the employee will not disclose nor use the trade secret. If the employee later discloses the trade secret to a new employer, there is a breach of the agreement. There is also a breach by the new employer. And if the employee rather than disclosing forms a new entity which begins to use the trade secret, there is a breach of the agreement.

The Achilles heel in enforcing trade secret agreements (or trade secrets protected under tort law) is the difficulty in proof of the use or disclosure of the trade secret. As stated in Greenberg v. Croydon Plastics Co., Inc.:

Plaintiffs in trade secret cases, who must prove by a fair preponderance of the evidence disclosure to third parties and use of the trade secret by the third parties, are confronted with an extraordinarily difficult task. Misappropriation and misuse can rarely be proved by convincing direct evidence. In most cases, plaintiffs must construct a web of perhaps ambiguous circumstantial evidence from which the trier of fact may draw inferences which convince him that it is more probable than not that what plaintiff alleged happened did in fact take place. Against this often delicate construct of circumstantial evidence, there frequently must be balanced defendants and defendants' witnesses who directly deny everything.

378 F. Supp. 806, 814 (E.D. Pa. 1974). See also, for the nasty procedural problems relating to trade secret litigation in Casey, K.R., Identification of Trade Secrets During Discovery: Timing and Specificity, 24 AIPLA Journal 191 (1994).

To recount, while the immediately preceding discussion has focused on the protection of trade secrets by contractual agreement, it is of course well-established that trade secrets may be protected in the absence of such agreement from misappropriation. An understanding of what constitutes a wrongful misappropriation of trade secrets as a tort will assist in an understanding of how non-disclosure agreements may be enlisted to supplement the relief available under trade secret tort law.

B. Trade Secrets -- The Basics

In a trade secret case, a plaintiff must prove that it possesses a trade secret, that it took reasonable steps to preserve the secrecy of that trade secret, and that the defendant breached a duty not to disclose or use the trade secret.

A trade secret is defined in the State of New Mexico in N.M.S.A. § 57-3A-2 as set forth infra, footnote 1. The definition is broad and focuses on competitive advantage appropriated by a competitor. United Centrifugal Pumps v. Cusimano, 9 USPQ 2d 1171 (W.D. Ark. 1988) (if the competitor is allowed to use the plaintiff's customer list without expenditure of time or money, it will have lower costs enabling it to unfairly compete with plaintiff); Head Ski v. Kam Ski Co., 158 F. Supp. 919 (D. Md. 1958) (the competitor would otherwise have to spend money on research or reverse engineering); Vulcan Refining Co. v. Assman, 173 N.Y.S. 334 (N.Y. Super. Ct. 1918) (the competitor would otherwise be forced to engage in expensive and time consuming chemical analysis).

In addition to the existence of a trade secret, the statute provides relief only if there is actual or threatened misappropriation. Misappropriation is defined as:

- 1) acquisition of a trade secret of another by a person who knows or has reason to know that the trade secret was acquired by improper means; or
- 2) disclosure or use of a trade secret of another without express or implied consent by a person who

- a) used improper means to acquire knowledge of the trade secret; or
- b) at the time of disclosure or use, knew or had reason to know that his knowledge of the trade secret was i) derived from or through a person who had utilized improper means to acquire it; ii) acquired under circumstances giving rise to a duty to maintain its secrecy or limit its use; or iii) derived from or through a person who owed a duty to the person seeking relief to maintain its secrecy or limit its use; or
- c) before a material change of his position, knew or had reason to know that it was a trade secret and that knowledge of it had been acquired by accident or mistake.

N.M.S.A. § 57-3A-2B. It will readily be seen that in addition to proof of acquisition and disclosure or use, the person seeking protection of the trade secret must prove that it was done without consent by a person who obtained access to the trade secret through one of three methods. The first method is “improper means” which is defined in Paragraph A of this same section as including “. . . theft, bribery, misrepresentation, breach or inducement of a breach of a duty to maintain secrecy or espionage through electronic or other means.” In addition to proscribing a person who has used improper means, to acquire the trade secret, the statute addresses those persons who acquire the trade secret not by improper means but with a certain state of knowledge. Thus, there is a violation of the statute if the person receiving the trade secret (the statute particularly contemplates the new employer) has knowledge that the person from whom it was derived had utilized improper means to acquire it (such as the former employee), or acquired the secret under circumstances giving rise to a duty to maintain its secrecy, or limit its use (the ex-employee who is not subject to a contract but took the trade secret in breach of a duty to maintain secrecy), or who had knowledge that the person (the ex-employee) owed a duty to the person seeking relief to maintain secrecy (the former employer). Another proscribed person is one who obtains the trade secret by

accident or mistake but before making a material change of his position based on the trade secret, acquires knowledge or has reason to know that the information was a trade secret of another.

In short, the statute proscribes both ex-employees, and anyone who receives the information through an ex-employee, regardless of whether or not the employee had signed a non-disclosure agreement. In the absence of the agreement, the duty not to disclose derives from the law of agency as set forth above.

The Uniform Trade Secrets Act (N.M.S.A. § 57-3A-1, et seq.) (see Appendix A) provides for injunctive relief in § 57-3A-3 and damages in § 57-3A-4. It further provides for attorneys fees to the prevailing party in three circumstances: 1) a claim of misappropriation is made in bad faith; 2) a motion to terminate an injunction is made or resisted in bad faith; or 3) willful and malicious misappropriation exists. The statute of limitations for an action for misappropriation is three years. N.M.S.A. § 57-3A-7. The use of protective orders to prevent disclosure of trade secrets during litigation is provided for in § 57-3A-6.

C. Examples of Trade Secret Protection

In Herzog v. "A" Co., 138 Cal. 3d 656 (1982), an employer attempted to prevent a former employee from accepting employment with a competitor based on a provision in an employment contract that forbade disclosing trade secrets. The court held that the mere fact that the employee would be working for an employer in a competitive business does not in itself prove that the employee will disclose trade secrets in violation of his or her agreement with the former employer.

In the area of using trade secrets to prevent disclosure by an ex-salesperson, it was held in Hollingsworth Solderless Terminal Co. v. Turley, 622 F.2d 1324 (9th Cir. 1980), that the court must look at three factors: 1) whether the information is readily accessible to a diligent competitor or sales person; 2) whether the customer's primary considerations are price, quality, and efficient service rather than the identity of the salesperson; and 3) whether the salesperson or competition intends to

injure the employer's business beyond an intention to take away business. That, of course, is a relatively severe application of trade secret law to a non-solicitation fact pattern.

In another case, interpreting the Uniform Trade Secret Act as adopted in California, American Paper & Packaging Prods., Inc. v. Kirgan, 183 Cal. 3d 1318 (1986), the court found that there was no trade secret in a customer list because the identities of the customers were readily ascertainable in the industry and the compilation process was "neither sophisticated nor difficult nor particularly time consuming." It is fairly typical in court holdings with respect to protection of customer or supplier lists to grant relief only where there is more than a mere compilation of names and addresses. The important element in these cases is to show that there was significant effort and/or expertise required in order to compile the customer lists. Sigma Chemical Co. v. Harris, 794 F.2d 371 (8th Cir. 1986). That is ordinarily shown when in addition to the customers' names and addresses, the list includes the requirements or needs of such customers, obtained as a result of continuous business between the employer and the customer involving the analysis of purchase orders with respect to quantity, type of products, time of ordering, and other valuable information that exists in a close customer-supplier working relationship. Nevertheless, in Excelsior Laundry Co. v. Diehl, supra, the court denied broad relief even though it admitted that the route salesman's customer list included not merely the names of patrons but the time and class of work supplied and the day and hour of week when it was to be called for.

In another area, the question arises as to whether employees, planning to depart the employer and to start a competing business, may notify customers either before or after termination of employment. In American Credit Indem. Co. v. Sacks, 213 Cal. 3d 622 (1989), the court held that former employees were entitled to announce a change of employment to a former employer's customers even where the identity of those customers was tantamount to a trade secret belonging to the former employer. The court stated:

[T]he right to announce a new affiliation, even to trade secret clients of a former employer, is basic to an individual's right to engage in fair competition. Therefore, the acquisition of trade secrets under circumstances giving rise to a duty to limit their use, as is the case here, clearly allows for such an announcement. To hold otherwise unnecessarily would contravene widely accepted and well-established business practices.

It is important to note that the case does not condone solicitation of the customers, but merely an announcement. Presumably, if a customer responds to the announcement, the ex-employee may make a pitch for the customer's business. That is not solicitation but responding to the customer's response to an announcement. It is apparent that drawing this fine distinction leads to plentiful litigation.

In a case that is particularly unpleasant for employers, Moss, Adams & Co. v. Shilling, 179 Cal. 3d 124 (1986), the court found that a customer list did not rise to the level of a trade secret because the clients became known to the ex-employees through personal contacts during earlier employment. Moreover, the fact that the employees took a Rolodex which included addresses, was deemed not to be important because it "merely saved [the ex-employees] from the minor inconvenience of obtaining the desired addresses through generally available sources."

It is extremely important for the employer to take appropriate steps necessary to maintain the information that it wishes to protect in secrecy. The Uniform Trade Secrets Act requires that efforts made to maintain secrecy be "reasonable under the circumstances". This may include executing non-disclosure agreements with employees, co-venturers, partners, licensees, customers, and suppliers. Access to areas within the company and documents should be on a need-to-know basis. Documents should be carefully destroyed through shredding or burn boxes. Documents should be clearly marked as "Confidential", "Proprietary", or "For Internal Use Only". Visitors at a plant should be signed in, plant tours should be limited, and where persons are allowed on plant tours into critical areas where trade secrets may be disclosed, a

non-disclosure agreement should be signed. Publications and speeches by employees should be reviewed and limited. When employees depart, exit interviews warning the employee of their obligations under a non-disclosure agreement and having the employee hand over all company documents, disks, etc., should be implemented. That may be followed by letter to a new employer advising the employer of the ex-employee's obligations under a prior non-disclosure agreement. If proper steps are not taken, the assertion that the plaintiff has a trade secret may fail. Motorola Inc. v. Fairchild Camera, 366 F. Supp. 1173 (D. Ariz. 1973); Future Plastics, Inc. v. Ware Shoals Plastics, Inc., 340 F. Supp. 1376 (D.S.C. 1972). In Hollingsworth Solderless Terminal Co., supra, the court emphasized that whether an employee was required to sign a confidential disclosure agreement is relevant in determining whether the employer properly pursued maintaining secrecy that was reasonable under the circumstances.

It is well established that there is no conflict between Federal patent laws and trade secret protection requiring federal preemption. Kewanee Oil Co. v. Vicron Corp., 416 U.S. 470, 481 (1974). A similar conclusion with respect to copyrights was reached in Computer Associates Int'l. v. Altai, 982 F.2d 693 (2d Cir. 1992).

D. Agreements

Attached as Appendices E and F are two agreements, one of which is an employment agreement (see Appendix F) including a covenant-not-to-compete, a non-disclosure provision, and a non-solicitation of customers and employees provision. It also includes liquidated damages for breach of the latter two covenants. This is a fairly aggressive agreement strongly in favor of the employer. The other agreement (see Appendix E) is an independent contractor (e.g., a technical consulting) agreement with non-solicitation, trade secret, confidentiality and intellectual property provisions attached as an exhibit (see Exhibit C Independent Contractor Agreement and Exhibit B thereto). It precludes the consultant from pursuing business directly with the employer's customers, provides rules for how the consultant will present itself to customers of the

employer, precludes disclosure or use of trade secret materials, prevents inadvertent disclosure by the consultant of trade secrets that the consultant may have acquired from others, precludes use of the employer's name, and requires an assignment of all inventions as well as other ideas created during the consulting relationship.

These Agreements and the rationale for certain clauses will be discussed by the presenters.