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Restrictive covenants evolve from common law to statutory regulation: the 2022 watershed

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Restrictive covenants were once the exclusive province of the common law in each state. That is no longer the case. So far, the applicable law remains state law (although there are proposals pending in Congress and at the Federal Trade Commission that portend regulation there). But, states now are supplementing or altering their common law with statutes.

Today, 30 states (including Washington, D.C.) have laws affecting restrictive covenants. Unlike state statutes regulating trade secrets (which largely follow the Uniform Trade Secrets Act), the state statutes governing restrictive covenants run a wide gamut. A quick look at those that became effective in late 2021 or are becoming effective in 2022 will illustrate patterns in that regulation.

These changes reflect an increasing hostility towards restrictive covenants. As a result, 2022 is far different than 2002 or even 2012.

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Employers need to reevaluate their restrictive covenant agreements in light of these changes and to appreciate that a "one size fits all" approach is unsustainable. Today, knowing the common law is far too little.

Colorado: the *In Terrorem* sanction

Colorado's new statute is novel in imposing criminal penalties (120 days in jail, a fine up to $750, or both) for employers violating its restrictive covenant statute.

On its face, compliance looks easy since there are four separate exceptions:

- Any contract for the purchase and sale of a business or the assets of a business;
- Any contract for the protection of trade secrets;
- Any contract providing for recovery of the expense of educating and training an employee who was employed by the employer for less than two years; or
- Any contract for executives, management personnel, and employees who constitute professional staff to such personnel.

But, easy is often an illusion.

It is difficult to predict how vigorously this law will be enforced by state and local prosecutors. For example, will suits to enforce restrictive covenants be countered routinely with parallel criminal proceedings upon the request of the defendant employee?

The risk of criminal sanctions is daunting to every business. Colorado's new law invites employers to minimize that risk by scaling back their use of restrictive covenants: *i.e.*, to be afraid of the potential risk of criminal sanctions for continuing to utilize restrictive covenants promiscuously. From now on, restrictive covenants have a downside risk for employers in Colorado.

Illinois: micromanagement?

The Illinois Freedom to Work Act ("IFWA") imposes limitations on non-compete and non-solicitation agreements for employees (but excepts confidentiality agreements and agreements in connection with the sale of a business). Its recent amendments effective for 2022 expand its comprehensive approach to regulating restrictive covenants for employees in Illinois.

Minimum annual compensation

Employers are prohibited from entering into non-compete agreements with employees unless the employee's actual or expected annualized rate of earnings exceed $75,000 per year. This benchmark minimum will increase by $5,000 every five years until that minimum reaches $90,000 in 2037.

There is also a separate minimum for non-solicitation agreements. Employers are prohibited from entering into those types of agreements with employees unless the employee's actual or expected annualized rate of earnings exceeds $45,000 per year. This benchmark minimum will increase by $2,500 every five years until that rate reaches $52,500 in 2037.

Minimum consideration

Separate and in addition to those minimum compensation levels, there is also an independent requirement for "adequate consideration" for non-compete and non-solicitation agreements.

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This is defined in the IFWA as an either/or:

- at least two years of work with the employer after signing a covenant not to compete or a covenant not to solicit; or
- other consideration adequate to support such an agreement, which could consist of a period of employment plus additional benefits or merely financial benefits on their own, such as a signing bonus or equity grant.

Mandatory garden leave for involuntary departures

Non-compete or non-solicitation agreements must provide compensation for situations where the employee loses his or her job as a result of business circumstances or governmental orders related to the COVID-19 pandemic. No paid garden leave is required for voluntary departures.

In comparison to legislation in other states, Nevada's approach seems more modest but proscribes two of the more common overreaches that occur in employing and enforcing non-competes.

For involuntary pandemic-related departures, this paid garden leave must include compensation equivalent to the employee's base salary at the time employment was terminated and running for the duration of the non-compete period, subtracting any compensation earned through subsequent employment during such period.

Mandatory advance notice

Non-compete and non-solicitation agreements are void unless:

- the employer advises the employee in writing to consult with an attorney before entering into the agreement; and
- the employer provides the employee with a copy of the agreement at least 14 calendar days before employment commences or the employer provides the employee with at least 14 calendar days to review the agreement.

Judicial remedies/judicial powers

These IFWA amendments permit courts, in their discretion, to reform or sever provisions rather than refuse to enforce the entire covenant. In short, Illinois courts have statutory discretion to "blue pencil" overbroad restrictions when the court thinks that is fair, right, and just.

IFWA also imposes a downside risk on employers: statutory attorney's fees for a prevailing employee. When an employee defeats an employer's effort to enforce a restrictive covenant in court or in arbitration, the employee will be able to recover from the employer all costs and reasonable attorney's fees.

Nevada: targeted limitations

Nevada also amended its statute governing non-compete agreements. In comparison to legislation in other states, its approach seems more modest but proscribes two of the more common overreaches that occur in employing and enforcing non-competes.

In employing non-competes, there is always the issue of whether the employer has a protectable interest. Nevada has now imposed a baseline: if employees are paid hourly, those employees lack the status to engender a protectable interest. Thus, non-competes for hourly employees are no longer permitted in Nevada.

In enforcing non-competes, the amended statute sets out a safe harbor where enjoining a former employee from working for a prior customer altogether is prescribed. This safe harbor for the departing employee is triggered when the customer follows the employee voluntarily and without solicitation and the employee is otherwise honoring his/her noncompete.

Oregon: procedural and substantive due process

Oregon enacted amendments to its non-compete statute effective January 1, 2022. Those amendments provide that non-compete agreements are void unless statutory mandates for both procedural and substantive due process have been met and limits those non-competes to a maximum of 12 months.

The procedural due process is notice. There is advance notice. Employers must advise prospective employees in a written employment offer at least two weeks before the employee begins work that a non-compete is a condition of employment. There is also post-employment notice. Employers must send the employee a reminder copy within 30 days after termination of employment.

While there is an exception for restrictions in the context of the sale of a business in the D.C. law, everything else under this D.C. law is worse for employers than California.

The substantive due process lies in the conditions limiting which employees may be restricted:

- Only employees engaged in administrative, executive, or professional work who perform predominantly intellectual, managerial, or creative tasks and exercise discretion and independent judgment while being paid on a salary basis;
- Only employees with a total gross salary and commissions at the time employment ends exceeding $100,533 (which will be adjusted annually for inflation); and
- Only employees for whom the employer has a protectable interest (e.g., the employee has access to trade secrets or

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competitively sensitive confidential business or professional information).

There is, however, a backdoor pass that employers may purchase. For employees falling short of those requirements, a non-compete agreement may still be enforceable if the employer agrees in writing to pay the greater of (i) 50% of the employee's annual base salary and commissions or (ii) 50% of $100,533, adjusted annually for inflation.

There are also potentially significant exceptions that might provide workarounds for certain employers. This Oregon law does not apply to either bonus restriction agreements (*i.e.*, reasonable non-compete agreements that upon breach result in a forfeiture of profit sharing or other bonus) or non-solicitation agreements.

Washington, D.C.: California on the Potomac?

Washington, D.C.'s legislative ban on non-compete agreements takes effect on April 1, 2022, but covers only agreements signed from that point on. This D.C. statute forbids employers from requiring or otherwise requesting an employee who performs work in D.C. to sign a non-compete agreement.

Historically, employers viewed California as the most difficult jurisdiction for imposing limits on employee mobility. Move over, California. While there is an exception for restrictions in the context of the sale of a business in the D.C. law, everything else under this D.C. law is worse for employers than California.

For example, this law prohibits exclusivity agreements *during* employment, and an employer's retaliatory conduct against an employee for providing services to another would subject the employer to fines. Plus, employers are required to provide their current workforce written notice of this law, and to provide such notice to new employees within 7 calendar days of hire.

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