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## Preserving Human Capital: Using the Noncompete Agreement to Achieve Competitive Advantage

Griffin Toronjo Pivateau

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# **PRESERVING HUMAN CAPITAL: USING THE NONCOMPETE AGREEMENT TO ACHIEVE COMPETITIVE ADVANTAGE**

GRIFFIN TORONJO PIVATEAU\*

I. The Paradox of Investment in Human Capital.....	320
II. The Law and Human Resources in Strategic Decision-Making .....	322
A. Management’s Use of the Law as an Element of Business Strategy .....	322
B. Management’s Use of Human Resources as an Element of Corporate Strategy .....	323
1. The Management of Human Resources Represents One of the Greatest Challenges That an Organization Can Face.....	323
2. A Key Element Distinguishes Human Capital .....	324
C. Employee Retention Reduces an Organization’s Costs.....	326
1. The Loss of Employees Can Damage an Organization .....	326
2. Organizations Incur Costs Connected with The Loss of Employees.....	327
3. Hiring of Key Employees by Competitors Can Cause Losses to the Organization.....	328
III. Use of the Noncompete Agreement as a Management Tool.....	329
A. Organizations Are Often Frustrated in Their Attempts to Retain Employees .....	329
1. Employees Will Leave Even in a Harsh Economy.....	329
2. Traditional Methods of Retaining Employees Often Fail to Work .....	330
B. The Intersection of Human Capital Theory and the Law .....	330
C. The Noncompete Agreement Can Form Part of the Human Resources Strategy .....	331
1. The Noncompete Agreement Explained .....	331
2. A Carefully Crafted Noncompete Agreement Will Prevent Employers from Losing Employees.....	331
IV. Crafting an Enforceable Noncompete Agreement .....	332
A. The Noncompete Agreement is Troublesome .....	332
B. Enforcement of the Noncompete Agreement Requires a Carefully Drafted Document.....	334
1. Limitations on Scope of Activity .....	335
2. Limitations on Time .....	336
3. Limitations on Geography.....	337
4. The Effect of the Blue-Pencil Doctrine .....	337

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C. How to Draft a Noncompete Agreement .....	339
D. Drafting a Noncompete Agreement that a Court Will Enforce .....	340
1. Calculating the Time Restraint.....	341
2. Calculating the Scope of Activity Restraint .....	341
3. Drafting the Geographic Restraint .....	342
E. Drafting a Noncompete Agreement that the Employee Will Sign.....	343
V. Conclusion .....	343

## I. THE PARADOX OF INVESTMENT IN HUMAN CAPITAL

Organizations today face numerous challenges: worldwide competitors, changes in information technology, increased reliance on knowledgeable workers, and a shifting economic environment.<sup>1</sup> In the face of this altered business climate, competitive advantage – a compelling reason to do business with an organization – is more vital than ever.<sup>2</sup> In response to new pressures, companies have been forced to modify internal structures, adopt new processes, and embrace fundamental changes to the nature of their business.<sup>3</sup> These changes have created significant implications for an organization’s employees.<sup>4</sup>

Faced with the difficulty of securing advantage by traditional means, management has increasingly focused on employees as a key asset and driver of productivity.<sup>5</sup> Companies have acknowledged the differences that employees can make.<sup>6</sup> Organizations have increasingly adopted the human capital theory, which holds that employees are an asset of an organization.<sup>7</sup> Human capital represents the competency and knowledge of an organization’s employees.<sup>8</sup> Although it is an intangible concept, human capital is just as real and important as physical assets. Today, market analysts determine a company’s value by looking not only to a firm’s balance sheet, but also to its human capital.<sup>9</sup>

Traditionally, companies have attempted to maintain competitive advantage by reducing costs and introducing new products.<sup>10</sup> Continual cost cutting is not a long term solution, though.<sup>11</sup> Competing on cost alone is difficult. As industries become increasingly commoditized, lower costs are available to most competitors

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<sup>1</sup> EDWARD E. LAWLER III, JOHN W. BOUDREAU & SUSAN ALBERS MOHRMAN, *ACHIEVING STRATEGIC EXCELLENCE: AN ASSESSMENT OF HUMAN RESOURCE ORGANIZATIONS 1* (Stanford Business Books 2006).

<sup>2</sup> BRADLEY W. HALL, *THE NEW HUMAN CAPITAL STRATEGY 4* (American Management Association 2008).

<sup>3</sup> LAWLER ET AL., *supra* note 1, at 1.

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> HALL, *supra* note 2, at 20.

<sup>7</sup> *Id.* at 24.

<sup>8</sup> *Id.*

<sup>9</sup> *Id.* at 21.

<sup>10</sup> *Id.* at 19.

<sup>11</sup> THOMAS O. DAVENPORT, *HUMAN CAPITAL: WHAT IT IS AND WHY PEOPLE INVEST IN IT 5* (Jossey-Bass Publishers 1999).

and are easily matched. Similarly, even a constant supply of innovative products cannot guarantee competitive advantage. In fast-moving, high-technology industries, for example, companies relentlessly produce new products and still struggle to keep up with competitors.<sup>12</sup>

In response to such competition, organizations will seek to maximize their human capital as a differentiator.<sup>13</sup> Presumably, an organization that invests in its human capital will be rewarded with increased productivity and higher returns.<sup>14</sup> But here is where the problem develops. Although it makes theoretical sense to label human capital as an asset, employees differ from other forms of assets.<sup>15</sup> Seemingly, an organization lacks an ownership interest in its employees and the human capital that they represent.<sup>16</sup> Only the employment relationship secures the retention of human capital.

Investment by an organization in human capital – its employees – leads to a paradox. To date, proponents of the human capital theory have been eager to create a new strategic role and have failed to address the following paradox. A company that invests in its employees, providing those employees with new skills and knowledge, will find that it has increased the employee's value. This added value, however, does not necessarily correspond to increased value for the employer. Instead, gained skills, knowledge, and experience will enhance the employee's marketability, permitting her to transfer the benefits of the organization's investment to a competitor. A company that invests in human capital without taking steps to secure that capital will find its investment flowing to the competition.<sup>17</sup>

The employment relationship, which binds human capital to the organization, is an odd beast. The employment relationship is regulated by more than just a contract; a complicated mix of common law and statutes is also at play. To preserve its investment in human capital, employers should understand this peculiar area of the law.

The law provides several tools to manage the employment relationship. The best tool to address the problem of preservation and retention of the organization's human capital is the noncompete agreement. A noncompete agreement, carefully drafted and tailored to the employee's situation, will help firms retain the benefits of investment in their workforce. Employees who are governed by a noncompete agreement are less likely to leave the company.<sup>18</sup> In the event that an employee decides to leave, the noncompete agreement will prevent this employee from immediately taking her new skills and experience to a competitor.

This article discusses the drafting of an enforceable noncompete agreement. Because of historical factors, organizations must carefully craft noncompete

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<sup>12</sup> HALL, *supra* note 2, at 19.

<sup>13</sup> *Id.* at 20.

<sup>14</sup> *Id.* at 21.

<sup>15</sup> *Id.* at 23.

<sup>16</sup> *Id.* at 6.

<sup>17</sup> See discussion *infra* Part II.C.

<sup>18</sup> See discussion *infra* Part II.C.

agreements. Courts have historically disfavored noncompete agreements and as a result, the enforcement of noncompetes is uncertain.<sup>19</sup> Moreover, states interpret the noncompete agreements differently, maintaining different standards and drafting requirements. Therefore, effective drafting of noncompetes demands consultation with legal counsel to ensure that the purpose of the document – the maintenance and preservation of human capital – can be realized.

## II. THE LAW AND HUMAN RESOURCES IN STRATEGIC DECISION-MAKING

### A. Management's Use of the Law as an Element of Business Strategy

Despite the continual intrusion of legal issues into the daily lives of businesses, the law remains an underutilized management tool.<sup>20</sup> To many managers, the legal department remains an enigma, a resource kept away from the strategy process, to be consulted only when in trouble. Management might bring lawyers in to memorialize a deal or to draft a contract, but management rarely takes advantage of the decision-making assistance that attorneys can provide. The temptation is to view the law in regulatory terms, rather than a tool to increase value and manage risk.

It would prove wiser for the company to use its lawyers to create value for the organization. The law sets forth a regulatory framework that governs business operations. It establishes the “rules of the game.”<sup>21</sup> A savvy management team will understand that the law extends beyond its role as a constraint.<sup>22</sup> Legally astute managers will seek to understand the law and the opportunities it presents, as well as the regulations it imposes.<sup>23</sup> Management's inability, or unwillingness, to incorporate the law into its decision-making processes reduces the competitiveness of the organization.

This is not to discount the most frustrating element of the law – its imprecision. The law is “rarely applied in a vacuum, and its applications to a given set of facts is often not clear-cut.”<sup>24</sup> Management personnel should understand that a great deal of uncertainty exists within the law. Slight differences in facts can provide an alternate legal outcome. The law is often mercurial – it may be difficult at times for legal counsel to produce an exact answer. Blind reliance on the law could prove costly because it can change rapidly. A legally astute management team will consider this and act accordingly.

Legal aspects surround every aspect of corporate strategy.<sup>25</sup> The law does not exist as a separate element; it should be incorporated into every employer's

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<sup>19</sup> See discussion *infra* Parts IV.A-B.

<sup>20</sup> Constance E. Bagley, *Winning Legally: The Value of Legal Astuteness*, 33 ACAD. MGMT. REV. 378, 378 (2008).

<sup>21</sup> DOUGLASS NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 3 (James Alt, ed., Cambridge University Press 1990).

<sup>22</sup> *Id.* at 73.

<sup>23</sup> Bagley, *supra* note 20, at 380.

<sup>24</sup> *Id.*

<sup>25</sup> *Id.* at 378.

skill set. The law offers numerous tools to assist management in managing risk and capturing value. To choose the best strategy tools, employers must be prepared to sit down with their attorneys, determine the areas where strategy can be improved, and formulate suitable plans. Companies can gain a competitive edge if they stop merely reacting to the regulatory aspects of the law and instead, proactively use the law as a management tool.

*B. Management's Use of Human Resources as an Element of Corporate Strategy*

*1. The Management of Human Resources Represents One of the Greatest Challenges That an Organization Can Face*

Successful management of human resources can provide a company with increased success; conversely, a failure to efficiently manage employees can cause a company to fail. Large companies usually have an entire human resources management team charged with all aspects of dealing with issues that employees will face. Traditionally, the human resources team filled a strictly administrative role, generally being tasked with the day-to-day management of employees.

In recent years, however, the role of the human resources team, and the professionals manning that team, has changed. A successful organization will understand the connection between trained and capable employees and organizational success. In today's environment, human resources departments should strive to attract, maintain, and manage employees in an efficient manner.<sup>26</sup> The role of human resources in an organization can include different functions and can change depending on the type of organization. Nevertheless, in general, a human resources department will manage recruitment, compensation decisions, career development, and employee retention. Human resources policies can add significant value to the organization.

The growth of human resources as an element in strategy decisions has led, in recent years, to the adoption of the theory of human capital by many human resources professionals.<sup>27</sup> Underlying human capital theory is the acknowledgment that an organization's employees are a factor of production like land or labor. Human capital is not, however, equivalent to labor. Human capital concentrates on the knowledge and skills that an employee brings to her position, not the employee's capacity to perform basic labor tasks.<sup>28</sup>

Human capital theory looks upon workers as "embodying a set of skills which can be 'rented out' to employers."<sup>29</sup> Human capital is collectively made up of the intangible resources provided by employees – the creative, innovative elements of the organization that can ensure the competitiveness of the

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<sup>26</sup> *Id.*

<sup>27</sup> ANGELA BARON & MICHAEL ARMSTRONG, HUMAN CAPITAL MANAGEMENT 5 (GBR: Kogan Page, Limited 2007).

<sup>28</sup> *Id.*

<sup>29</sup> BARON & ARMSTRONG, *supra* note 27, at 5.

organization.<sup>30</sup> The overall knowledge that workers have, whether gained through formal or informal training, represents productive capital, part of the stock of knowledge available to an organization.<sup>31</sup> Thus, human capital represents an intangible asset of the company, much like intellectual property, corporate branding, and goodwill.

Some commentators view the human capital concept as the link between human resources and business performance.<sup>32</sup> This perspective allows management to view employees as assets that are as important to success as any physical asset. Human capital represents the “combined intelligence, skills, and expertise that gives the organization its distinctive character.”<sup>33</sup>

Human capital may be likened to physical capital in certain respects. The foundations of human capital are people and their skill-sets, while physical capital derives from facilities and equipment.<sup>34</sup> Employee skills will theoretically bring value to an organization in the same way that a physical asset contributes to the firm’s performance.<sup>35</sup> The theory of human capital management has transformed the traditional view of human resources. Firms have increasingly begun to redefine employees as resources rather than costs.<sup>36</sup>

## 2. A Key Element Distinguishes Human Capital

An organization does not own human capital in the way that it owns intellectual property. Employees are not indentured to the service of the organization. Rather, “[w]ork is a two-way exchange of value, not a one-way exploitation of an asset by its owner.”<sup>37</sup> Typically, the employment relationship is the only thing that secures human capital to the organization.<sup>38</sup> Employees bring their education and talents to their jobs. The employees own these skills and decide if, when, and where they will contribute this capital to the organization.

An employer will invest in human capital to increase performance, to reduce costs, and to improve efficiency. An employer who invests in human capital can expect to reap rewards in the form of increased productivity and profit.<sup>39</sup> Investments in training people and developing talent provide a way of attracting and retaining employees. A firm gains a competitive advantage when its strategies are not simultaneously being used by competitors.<sup>40</sup> Human capital theory proposes that organizations’ investments in people will lead to returns that exceed those investments.

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<sup>30</sup> *Id.*

<sup>31</sup> *Id.* at 6.

<sup>32</sup> *Id.*

<sup>33</sup> *Id.* at 8.

<sup>34</sup> *Id.* at 10.

<sup>35</sup> BARON & ARMSTRONG, *supra* note 27, at 10.

<sup>36</sup> *Id.*

<sup>37</sup> *Id.* at 5.

<sup>38</sup> *Id.* at 9.

<sup>39</sup> *Id.*

<sup>40</sup> Jay Barney, *Firm Resources and Sustained Competitive Advantage*, 17 J. MGMT. 99, 102 (1991).

An employee will also benefit from the organization's investment in human capital. The employee will often receive greater income, higher satisfaction from the performance of her duties, opportunities for advancement, and perhaps greater job security.<sup>41</sup> Unfortunately for the organization, its investment in the employee will also likely permit the employee to receive training, experience, and a skill set that will further enhance the employee's marketability. An investment in human capital may increase the employee's value, while also enhancing the likelihood that the employee will transfer those skills to another organization. An organization that places emphasis on the development of human capital runs the risk of diminished returns if highly trained employees migrate to competitors. From this standpoint, employees are like "free agents who can choose how and where they invest their talents, time, and energy."<sup>42</sup>

A corporation's focus on human capital management is understandable. Many organizations, in their annual reports and otherwise, stress the value of their employees and represent them as one of the most important assets of the business.<sup>43</sup> A 1998 study of U.S. corporations found that "firms with the greatest intensity of HR practices that reinforce performance had the highest market value per employee."<sup>44</sup> Compensating employees represents one of the largest costs of any business.<sup>45</sup> In fact, compensation may represent up to 80% of the total cost of doing business in service organizations.<sup>46</sup>

But compensation cost is just one aspect of human capital.<sup>47</sup> The performance of a corporation is dependent in large part on human capital.<sup>48</sup> Organizations must necessarily depend on capable, motivated employees to succeed.<sup>49</sup> As knowledge becomes more important to an organization, employees must grow in their ability to manage that knowledge.<sup>50</sup> Although human capital may not be shown on balance sheets of an organization, it makes up a large percentage of a company's value.<sup>51</sup> In this sort of economy, "a firm's strategy must be closely linked to its human talent."<sup>52</sup>

In the past decade, studies have demonstrated that effective human resource practices can add value to an organization.<sup>53</sup> Improvements in human resources practices can lead to significant increases in the market value of an organization.<sup>54</sup> Firms that succeed are those that can achieve "both operational and strategic

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<sup>41</sup> BARON & ARMSTRONG, *supra* note 27, at 9.

<sup>42</sup> *Id.* at 11.

<sup>43</sup> LAWLER ET AL., *supra* note 1, at 1.

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

<sup>49</sup> LAWLER ET AL., *supra* note 1, at 1.

<sup>50</sup> *Id.*

<sup>51</sup> *Id.*

<sup>52</sup> *Id.* at 2.

<sup>53</sup> *See, e.g., id.* at 1.

<sup>54</sup> *Id.* at 2.



excellence in the human resources systems.”<sup>55</sup>

Under human capital theory, the human resources department still fulfills its customary role.<sup>56</sup> But more importantly, the department is elevated into a position of “business partner.”<sup>57</sup> Under this approach, the human resources department contributes to the business performance, by providing effective management of one of the most important elements of a business, the human capital. By acting as a partner in developing strategy, the department can actively participate in planning and implementing strategy.<sup>58</sup>

### *C. Employee Retention Reduces an Organization’s Costs*

#### *1. The Loss of Employees Can Damage an Organization*

Business success requires an employer to manage costs carefully. In today’s uncertain economic climate, it seems more important than ever to reduce operating costs. Reducing such costs, in conjunction with increased cash flow, is “an effective business strategy to adopt in response to threats of economic survival.”<sup>59</sup> Many companies are seeking ways to reduce operational costs. Whether by seeking to control the acquisition costs of goods or increasing productivity, companies have sought different means to reduce such costs. Nevertheless, a number of firms have failed to address one key area of costs: human resources.<sup>60</sup>

Efficient management of human resources can lessen the rate at which employees leave, and thus reduce costs. Employee turnover refers to the rate at which an employer gains and loses employees. High turnover damages an organization’s productivity. A company that loses skilled workers, and in return gains a high percentage of novice workers, will necessarily suffer. Despite a lack of studies of costs and benefits related to the behavior and activities of human resources,<sup>61</sup> it seems certain that employee turnover costs money – money that could be better utilized elsewhere. Employers, faced with competitive threats in very uncertain times, must seek to reduce turnover and retain employees.

From this, it is evident that there are two dimensions to turnover costs. First, the organization suffers an array of direct costs connected with the loss of the employee. Second, the organization can suffer losses caused by the hiring of the employee by a competitor. While the latter might not seem as apparent, these losses can be just as detrimental.

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<sup>55</sup> *Id.*

<sup>56</sup> *Id.*

<sup>57</sup> *Id.*

<sup>58</sup> *Id.*

<sup>59</sup> Aharon Tziner & Assa Birati, *Assessing Employee Turnover Costs: A Revised Approach*, 6 HUMAN RES. MGMT. REV. 113, 113 (1996).

<sup>60</sup> *Id.* (citing WAYNE F. CASCIO, *MANAGING HUMAN RESOURCES: PRODUCTIVITY, QUALITY OF WORK LIFE, AND PROFITS* (McGraw Hill 3d ed. 1991)).

<sup>61</sup> *Id.* at 113-14.

## 2. Organizations Incur Costs Connected with The Loss of Employees

Employee turnover is expensive. The Employment Policy Foundation (“EPF”) has estimated average turnover costs as approximately twenty five percent of an employee’s annual salary.<sup>62</sup> In December 2002, EPF estimated a turnover cost of \$12,506 per full-time vacancy for the average employee, average compensation of \$50,025, and an annual 23.8% turnover rate.<sup>63</sup> With this average turnover rate, a Fortune 500 company faces turnover costs of approximately \$119 million per year.<sup>64</sup> A one percent reduction in the turnover rate for the company would lead to savings of \$5 million annually.<sup>65</sup> Other sources estimate turnover costs even higher.<sup>66</sup> Where do these costs come from? Some experts point to “advertising and recruiting expenses, orientation and training of the new employee, decreased productivity until the new employee is up to speed, and loss of customers who were loyal to the departing employee.”<sup>67</sup>

The costs of employee turnover can be both substantial and pervasive. Some commentators describe four classes of expenses associated with employee turnover: separation costs, replacement costs, training costs, and reduced productivity costs.<sup>68</sup>

Other studies have questioned this four-tiered model of employee turnover

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<sup>62</sup> Employment Policy Foundation, *Employee Turnover is Expensive*, Oct. 22, 2004, at 2, <http://www.super-solutions.com/pdfs/EmployeeTurnoverExpensive2004.pdf>.

<sup>63</sup> Employment Policy Foundation, *Balancing Act*, Mar. 11, 2004, at 5, [http://wfnetwork.bc.edu/downloads/EPF/EPF\\_Telework.pdf](http://wfnetwork.bc.edu/downloads/EPF/EPF_Telework.pdf).

<sup>64</sup> *Id.*

<sup>65</sup> *Id.*

<sup>66</sup> BEVERLY KAYE, LOVE ‘EM OR LOSE ‘EM: GETTING GOOD PEOPLE TO STAY 13 (Berrett-Koehler Publishers 2002).

<sup>67</sup> Beverly Kaye & Sharon Jordan-Evans, *Retention: Tag, You’re It!*, TRAINING & DEVELOPMENT, Apr. 2000, at 29, [http://www.jeg.org/pdf/Tag\\_Your\\_It.pdf](http://www.jeg.org/pdf/Tag_Your_It.pdf).

<sup>68</sup> CASCIO, *supra* note 60, at 623-25. Cascio breaks down these costs as follows:

Separation costs, comprised of the following elements:

Exit interview costs - the time value of the interviewer and the departing employee;

Administrative costs - the costs associated with the departure of the employee; and,

Severance pay - post-separation compensation paid to the departing employee.

*Id.* at 623.

Replacement costs, which include advertising costs, administrative costs associated with processing applications, interview expenses, testing, the costs of meetings to discuss the hiring decision, medical examinations, and orientation costs.

*Id.* at 623-24.

Training costs, including a host of costs associated with a new employee. Remember too that the costs associated with training are not just formal training procedures, but also on-the-job training as well as the time spent coming up to speed on workplace conduct and values.

*Id.* at 624.

Reduced productivity cost - the cost of the lower level of productivity of the new employee during the time before the employee reaches a comparable level of productivity.

*Id.*

costs. For example, one study suggests that the original model underestimated the costs associated with the loss of good employees.<sup>69</sup> Accordingly, numerous negative consequences flow from the loss of high performers.<sup>70</sup> This revised methodology breaks cost elements into three categories:

1. The direct outlays to the firm incurred by the replacement process: recruiting, hiring, training, and socializing new employees including the extra effort by supervisors and coworkers to integrate them;
2. The indirect costs and losses that relate to interruptions in production, sales, and the delivery of goods and services to customers; and
3. The financial value of the estimated effect on performance as a result of the drop in morale of the remaining work force following a dysfunctional turnover.<sup>71</sup>

Another category of costs associated with the loss of employees is socialization for new employees. Socialization is the “the process of acquiring the relevant information that employees must know in order to adequately perform their jobs.”<sup>72</sup> Socialization takes time, and an extended socialization process results in high financial costs for the firm. There are three aspects to the costs associated with socialization: the time required by the new employee, the reduced productivity from coworkers who must necessarily assist the new employee, and the costs of supervisor time.<sup>73</sup>

Regardless of the methodology employed, one can readily determine that employee turnover is costly to the employer. Organizations should do all they can to avoid losing employees.

### *3. Hiring of Key Employees by Competitors Can Cause Losses to the Organization*

There are also costs caused by the hiring of employees by competitors. When an organization loses key employees to a competitor, the hiring competitor gains important advantages over the original organization.<sup>74</sup> Complex routines, which are not easily imitated, presumably do not rely on any single individual. Under this perspective, a company losing an individual could rely on the strength of the routine to escape any losses based on the employee’s absence.

Thus, advantages from complex routines are lost when key employees join

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<sup>69</sup> See generally John Sullivan, *Not All Employee Turnover Is Bad – Celebrate Losing the Losers*, ERE.NET, Apr. 6, 2009, available at <http://www.ere.net/2009/04/06/not-all-employee-turnover-is-bad-celebrate-losing-the-losers/> (classifying employee turnover and reasons for departure into categories by desirability).

<sup>70</sup> Tziner & Birati, *supra* note 59, at 114-15.

<sup>71</sup> *Id.* at 116.

<sup>72</sup> *Id.* at 115.

<sup>73</sup> *Id.*

<sup>74</sup> Federico Aime, Scott Johnson, Jason W. Ridge & Aaron D. Hill, *The Routine May Be Stable But the Advantage is Not: Competitive Implications of Key Employee Mobility*, 31 STRATEGIC MGMT. J. 76 (2010).

competitors.<sup>75</sup> A recent study revealed that the loss of key employees by an organization hurts in three ways.<sup>76</sup> First, the hiring competitor gains knowledge about the organization – information that can be used to defend or imitate the organization.<sup>77</sup> Second, through the process of diffusion, other organizations also gain access to the knowledge of the original organization, allowing those firms to also imitate the routines for strategic advantage.<sup>78</sup> Finally, the diffusion of the knowledge will cause competitors to search for ways to improve performance against the original routines.<sup>79</sup>

### III. USE OF THE NONCOMPETE AGREEMENT AS A MANAGEMENT TOOL

#### *A. Organizations Are Often Frustrated in Their Attempts to Retain Employees*

##### *1. Employees Will Leave Even in a Harsh Economy*

Why do employees leave? The greater number of layoffs and discharges has been responsible for most employee separation in the past year, but this is not characteristic of business this century. From December 2000 until November 2008, the proportion of voluntary employment separations (“quits”) exceeded the proportion of layoffs and discharges every month.<sup>80</sup> Obviously, the economic crisis of 2009 has interrupted this pattern. Recent trends, however, indicate that quits will again regain their former position as the primary means of employee separation. The proportion of separations due to quits fell to a low of thirty-eight percent in April 2009 but rose to forty-five percent in November 2009.<sup>81</sup> The proportion of separations due to layoffs and discharges rose to a high of fifty-five percent in July 2009 but has since dropped to forty-seven percent in November 2009.<sup>82</sup> These statistics indicate that employees will leave their employment voluntarily even in harsh economic times. As the economy recovers, voluntary separation will likely regain its position as the primary reason for employee loss.

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<sup>75</sup> *Id.* at 84.

<sup>76</sup> *Id.* at 76. The study examined the San Francisco 49ers and the games played during the 24-year period between 1979 and 2002, when the team developed the strategic innovation known as the West Coast Offense. *Id.* at 78-79. Bill Walsh, coach of the 49ers during much of that period, generally receives credit as the inventor of the West Coast Offense. *Id.* The study examined all the games played during that period and analyzed the effect of the loss of Walsh’s assistant coaches. *Id.* at 76.

<sup>77</sup> *Id.* at 80.

<sup>78</sup> *Id.*

<sup>79</sup> *Id.*

<sup>80</sup> U.S. Bureau of Labor and Statistics, *Job Openings and Labor Turnover – November 2009*, U.S. DEPARTMENT OF LABOR NEWS RELEASE, Jan. 2010, at 4, <http://www.bls.gov/news.release/archives/jolts01122010.pdf>.

<sup>81</sup> *Id.*

<sup>82</sup> *Id.*

## 2. *Traditional Methods of Retaining Employees Often Fail to Work*

Organizations often find themselves frustrated by their attempt to lessen turnover. Traditionally, companies resort to increasing spending on employees as a solution.<sup>83</sup> Spending efforts are initially manifested by raising employee salaries.<sup>84</sup> If that fails to work, companies might try increasing training budgets for new employees and entry-level supervisors.<sup>85</sup> In the latter part of the 20th century, companies increasingly found that these traditional remedies failed to cure the problem.<sup>86</sup> Even if higher pay was available, the extra compensation failed to have the desired effect on employees. Similarly, increases in training failed to address the problem of employee turnover.<sup>87</sup>

Thus, even in relatively harsh economic times, many employees will voluntarily leave their employment. An employer seeking to preserve its investment in its employees must take affirmative steps to preserve the employment relationship.

### *B. The Intersection of Human Capital Theory and the Law*

Organizations face a troubling paradox. Human capital theory stresses the value of the employee<sup>88</sup> and supports the perception of employees as assets, rather than costs. Human capital theory supposes that investments in employees – in training and greater remuneration – will increase returns to the company.<sup>89</sup> The reality is, however, that the investment provided by the organization will inevitably increase the value of the employee, and enhance his or her ability to transfer that investment to a competitor. As explained more fully below, the loss of a key employee to a competitor enhances the competitive advantage of that competitor.

What is the employer to do? Embrace the utility and potential advantage stressed by human capital theorists, while merely hoping that it does not lose the value of that investment? How is an organization to manage this risk? Fortunately, a solution exists.

The law provides employers with a valuable tool to manage risks, increase value,<sup>90</sup> and assist an organization seeking to maximize the return on its investment in human capital: the noncompete agreement. A carefully crafted noncompete agreement, made specific to the employee and to his or her work for the company, will ensure that an organization increases its return on its investments in human capital.

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<sup>83</sup> Carl R. Weinberg, *Stop the Job Hop*, CHIEF EXECUTIVE 44 (April 1997).

<sup>84</sup> *Id.* at 46.

<sup>85</sup> *Id.*

<sup>86</sup> *Id.*

<sup>87</sup> *Id.*

<sup>88</sup> JAC FITZ-ENZ, *THE ROI OF HUMAN CAPITAL: MEASURING THE ECONOMIC VALUE OF EMPLOYEE PERFORMANCE 1* (New York: Amacom Books, 2000).

<sup>89</sup> *Id.*

<sup>90</sup> Bagley, *supra* note 20, at 383.

### *C. The Noncompete Agreement Can Form Part of the Human Resources Strategy*

#### *1. The Noncompete Agreement Explained*

A noncompete agreement is “an agreement, generally part of a contract of employment or a contract to sell a business, in which the covenantor agrees for a specific period of time and within a particular area to refrain from competition with the covenantee.”<sup>91</sup> The noncompete agreement is known by other names, most notably as a “covenant not-to-compete,” a “restrictive covenant,” or a “non-compete clause.”<sup>92</sup> These terms are interchangeable and all refer to an employment contract or provision purporting to limit an employee’s power upon leaving his or her employment, to compete in the market in which the former employer does business.<sup>93</sup>

In the employment context, noncompete agreements are generally directed at four discrete areas: (1) general noncompetition; (2) customer (or client) non-solicitation; (3) employee non-solicitation; and (4) non-disclosure.<sup>94</sup> But these four different areas are regularly intermingled. Noncompete agreements may, and often do, contain some or all of these protective clauses.

Noncompete agreements, in theory at least, are not meant to punish the former employee.<sup>95</sup> Instead, they are meant to protect the employer from unfair competition.<sup>96</sup> Noncompete agreements arguably protect an employer’s customer base, trade secrets, and other information vital to its success. From this perspective, noncompete agreements encourage employers to invest in their employees. An employer does not wish to invest in an employee only to see the employee take the skills acquired, or the company’s customers, to another employer. Logically, the employer will invest more in the employee if measures are in place to guard against the employee’s movement to a competitor.

#### *2. A Carefully Crafted Noncompete Agreement Will Prevent Employers from Losing Employees*

The noncompete agreement discourages employee movement. An enforceable noncompete agreement will prevent an employee from working for a competitor for a specified length of time. Arguably, there are few employees that can readily absorb a long term of inactivity, a term that could last up to three years based on a typical noncompete agreement. While noncompete agreements do not completely cure employee turnover, they act as a considerable deterrent. A

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<sup>91</sup> BLACK’S LAW DICTIONARY 364 (6th ed. 1990).

<sup>92</sup> But, since no substantive difference exists among the names, this Article will collectively refer to such covenants as “noncompete agreements.”

<sup>93</sup> Reddy v. Cmty. Health Found. of Man, 298 S.E.2d 906, 917 (W. Va. 1982).

<sup>94</sup> Kenneth J. Vanko, “*You’re Fired! And Don’t Forget Your Non-compete ...*”: *The Enforceability of Restrictive Covenants in Involuntary Discharge Cases*, 1 DEPAUL BUS. & COM. L.J. 1, 2 (2002).

<sup>95</sup> See *Superior Gearbox Co. v. Edwards*, 869 S.W.2d 239, 247 (Mo. Ct. App. 1993).

<sup>96</sup> William M. Corrigan & Michael B. Kass, *Non-Compete Agreements and Unfair Competition - An Updated Overview*, 62 J. MO. B. 81, 81 (2006).

noncompete agreement, even if never enforced, will provide a strong disincentive to leave a job.

Moreover, an employee restrained by a noncompete agreement will have a more difficult time finding a new place to work. Employers understand that it is difficult to poach employees who have agreed to a noncompete agreement. An organization seeking to hire away key employees from a competitor will be aware that those employees may not be able to start work in the near term. An employee forced to the sidelines for a year or more is considerably less desirable to another employer.

The noncompete agreement inhibits competitors in another way. A company that hires an employee away from a competitor, knowing that the employee has a contractual obligation to not work for a competitor, runs the risk of being sued for tortious interference with a contract.<sup>97</sup> A company that encourages a new hire to breach her noncompete agreement may be liable under this tort. The original employer then may have a suit not only against its former employee for breach of the noncompete agreement, but also against the hiring competitor for encouraging the former employee to breach her contractual obligations.<sup>98</sup>

#### IV. CRAFTING AN ENFORCEABLE NONCOMPETE AGREEMENT

##### A. *The Noncompete Agreement is Troublesome*

Courts have traditionally viewed noncompete agreements with disfavor, believing that the agreements contravene public policy.<sup>99</sup> The agreements were seen as unfair restraints on trade and in response, the common law prohibited the use of such agreements. In time, the restrictions on such agreements lessened.<sup>100</sup> Nevertheless, the common law has generally restricted their use for any purpose other than for legitimate business purposes.<sup>101</sup> To ensure the purpose is legitimate,

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<sup>97</sup> In *Lumley v. Wagner*, 42 Eng. Rep. 687 (1852), a singer under contract to sing at the plaintiff's theater was induced by the defendant, who operated a rival theater, to break her contract. The court held that the plaintiff was entitled to recover money damages from the rival theater owner for his interference with the singer's contract, which was essentially a form of unlawful competition. This case is the basis for the tort of inducement to breach a contract.

<sup>98</sup> *Id.*

<sup>99</sup> Michael Garrison and John Wendt, *The Evolving Law of Employee Noncompete Agreements: Recent Trends and an Alternative Policy Approach*, 45 AM. BUS. L.J. 107, 112-13 (2008).

<sup>100</sup> *Id.* at 114.

<sup>101</sup> See, e.g., *Allen, Gibbs, & Houlik, L.C. v. Ristow*, 32 Kan. App. 2d 1051; 94 P.3d 724 (2004); see also M. Scott McDonald, *Noncompete Contracts: Understanding the Cost of Unpredictability*, 10 TEX. WESLEYAN L. REV. 137 (2003). McDonald notes that among the recognized protectable interests for employers are:

- (1) to protect trade secrets and confidential information of the company;
- (2) to protect customer goodwill developed for the company (customer relationships);
- (3) to protect overall business goodwill and assets that have been sold (noncompetes used in the sale of a business);
- (4) to protect unique and specialized training;
- (5) for situations in which the employer has contracted for the services of an individual of unique value because of who they are (e.g., performers, professional

the law requires that a valid noncompete agreement meet a reasonableness requirement.<sup>102</sup>

The reasonableness requirement is designed to balance the interests of all entities affected by the noncompete agreement: the employer, the employee, and society as a whole. Each entity has an interest to be protected. The employee wishes to preserve his mobility; the employer wishes to protect itself from unfair competition; and society wishes to balance with a system that provides incentives for the development and training of employees. With such varied interests at hand, the successfully drafted noncompete agreement must be sculpted carefully as to satisfy all three parties.

To satisfy the reasonableness requirement, the law requires that the employer establish a reason for the noncompete agreement other than preventing the employee from competing with his former employer.<sup>103</sup> There must be some element to the competition that would make such competition unfair. The employer's justification cannot simply consist of the training or experience gained while on the job because an employee has a right to those things. Instead, the employer must demonstrate the existence of "special circumstances" that are present to justify the use of the noncompete agreement.<sup>104</sup>

Courts have acknowledged two goals as sufficient justification for the execution of a noncompete agreement.<sup>105</sup> An employer is entitled to (1) protect the goodwill of its business and (2) protect its trade secrets.<sup>106</sup>

An employee often generates goodwill in his conduct with clients, fostering personal relationships with customers. That goodwill does not, however, belong to the employee, who has conducted business as an agent of the employer. Instead, the goodwill is an asset of the employer. The law protects these corporate customer relations as part of the "customer contact" theory.<sup>107</sup>

The employer also has a right to protect its trade secrets. An employer can utilize a number of legal documents to secure these secrets.<sup>108</sup> Still, a noncompete agreement is useful as a supplementary form of protection. The noncompete agreement protects trade secrets in the best manner possible – by preventing the former employee from working for a competitor.<sup>109</sup> Thus, the employer is able to prevent the sharing of trade secrets before the disclosure ever takes place.<sup>110</sup> A noncompete agreement is a strong prophylactic remedy that aims to prevent

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athletes); and

(6) for pinnacle employees in charge of an organization.

*Id.* at 143 (footnotes omitted).

<sup>102</sup> *Id.*

<sup>103</sup> *Id.* at 115.

<sup>104</sup> *Id.* at 115-16.

<sup>105</sup> *Id.* at 116.

<sup>106</sup> *Id.*

<sup>107</sup> M. Scott McDonald, *Noncompete Contracts: Understanding the Cost of Unpredictability*, 10 TEX. WESLEYAN L. REV. 137 (2003).

<sup>108</sup> *Id.*

<sup>109</sup> *Id.* at 117.

<sup>110</sup> *Id.*



unwanted disclosures rather than having to sue for misappropriation of trade secrets after the fact.

*B. Enforcement of the Noncompete Agreement Requires a Carefully Drafted Document*

Establishing the existence of a legitimate business interest to be protected is merely the threshold step that an employer must meet to create an enforceable agreement.<sup>111</sup> The scope of the noncompete agreement must not be greater than the business interest at stake.<sup>112</sup> Almost all courts apply a standard of reasonableness in deciding whether to enforce a noncompete agreement.<sup>113</sup> As will be seen below, however, “reasonableness” as a standard holds minimal value in the construction of noncompete agreements.<sup>114</sup>

Nineteen states provide a statutory framework for the regulation of noncompete agreements. In contrast, the remaining states rely on the court system.<sup>115</sup> In common law jurisdictions, a noncompete agreement will be upheld only “if the restraint imposed is not unreasonable, is founded on a valuable consideration, and is reasonably necessary to protect the interest of the party in whose favor it is imposed, and does not unduly prejudice the interests of the public.”<sup>116</sup> Many states follow the test set forth in the *Restatement (Second) of Contracts*, which takes into consideration the following factors: (1) whether the restriction is greater than necessary to protect the business and goodwill of the employer; (2) whether the employer’s need for protection outweighs the economic hardship which the covenant imposes on the departing party; and (3) whether the restriction adversely affects the interests of the public.<sup>117</sup>

Once a court determines that the noncompete agreement protects a legitimate business interest, it will then examine the agreement to ensure that it does not

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<sup>111</sup> *Id.*

<sup>112</sup> *Id.* at 118.

<sup>113</sup> *Id.* at 117-18; *Reddy v. Cmty. Health Found. of Man*, 298 S.E.2d 906, 910-11 (W. Va. 1982).

<sup>114</sup> The court in *Reddy* put it best:

Reasonableness, in the context of restrictive covenants, is a term of art, although it is not a term lending itself to crisp, exact definition. Reasonableness, as a juridical term, is generally used to define the limits of acceptability and thus concerns the perimeter and not the structure of the area it is used to describe. This general observation is nowhere more particularly true than with respect to a restrictive covenant. Once a contract falls within the rule of reason, the rule operates only as a conclusive observation and provides no further guidance. A court’s manipulation of the terms of an anticompetitive covenant, where none of its provisions standing alone is an inherently unreasonable one, cannot be accomplished with reasonableness as the standard. It is like being in the jungle – you’re either in or you’re out, and once you’re in the distinction is worthless for establishing your exact location.

*Reddy*, 298 S.E.2d at 910-11.

<sup>115</sup> *Vanko*, *supra* note 94, at 2.

<sup>116</sup> *W.R. Grace & Co., Dearborn Div. v. Mouyal*, 422 S.E.2d 529, 531 (Ga. 1992) (quoting *Rakestraw v. Lanier*, 30 S.E. 735, 738 (Ga. 1898)).

<sup>117</sup> RESTATEMENT (SECOND) OF CONTRACTS § 188 cmt. a (1979).

exceed the minimum restraint necessary to protect that interest.<sup>118</sup> Courts will enforce agreements only where they are “strictly limited in time and territorial effect and . . . [are] otherwise reasonable considering the business interest of the employer sought to be protected and the effect on the employee.”<sup>119</sup> In common law jurisdictions, noncompete agreements are enforced as reasonable if they are found to satisfy the following three elements:

First [the agreement] must be ancillary to an otherwise valid contract, transaction or relationship. Second, the restraint created must not be greater than necessary to protect the promisee’s legitimate interests such as business goodwill, trade secrets, or other confidential or proprietary information. Third, the promisee’s need for the protection given by the agreement must not be outweighed by either the hardship to the promisor or any injury likely to the public.<sup>120</sup>

Thus, to be enforceable, agreements must be reasonable in three ways: scope (referring to the subject matter of the agreement), duration, and geography.<sup>121</sup>

### *1. Limitations on Scope of Activity*

There are two general types of “scope of activity” limitations: those that prohibit the employee from soliciting the employer’s customers and those that prohibit the employee from engaging in any competitive business. With respect to customer solicitation, “reasonable” limitations are valid and enforceable.<sup>122</sup> A legitimate purpose of a noncompete agreement is to prevent “employees or departing partners from using the business contacts and rapport established during the relationship of representing [a] . . . firm to take the firm’s customers with him.”<sup>123</sup> Thus, noncompete agreements that are limited to those customers with

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<sup>118</sup> Garrison & Wendt, *supra* note 99, at 117.

<sup>119</sup> Palmer & Cay, Inc., v. Marsh & McLennan Co., 404 F.3d 1297, 1303 (11th Cir. 2005).

<sup>120</sup> Peat Marwick Main & Co. v. Haass, 818 S.W.2d 381, 386 (Tex. 1991) (citations omitted). In Texas, the common law test was later codified in the Texas Business and Commerce Code.

<sup>121</sup> See UARCO Inc. v. Lam, 18 F. Supp. 2d 1116, 1121 (D. Haw. 1998) (noting parameters of reasonableness inquiry); Pinnacle Performance, Inc. v. Hessing, 17 P.3d 308, 311 (Idaho Ct. App. 2001) (explaining the three factors considered in a reasonableness inquiry).

<sup>122</sup> See Ruscitto v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 777 F. Supp. 1349, 1354 (N.D. Tex. 1991) (limiting the solicitation for one year of any of the clients of Merrill Lynch “whom [the employee] served or whose names became known to [the employee] while [working at] Merrill Lynch” was reasonable), *aff’d*, 948 F.2d 1286 (5th Cir. 1991), *cert. denied*, 504 U.S. 930 (1992); Picker Int’l v. Blanton, 756 F. Supp. 971, 982 (N.D. Tex. 1990) (holding that the limitation against servicing MRI systems that employee serviced while with employer was reasonable); Investors Diversified Servs., Inc. v. McElroy, 645 S.W.2d 338, 339 (Tex. App. 1982) (holding that the limitation against soliciting customers with whom the employee dealt or had contact during employment was reasonable).

<sup>123</sup> *Peat Marwick*, 818 S.W.2d at 387. Some customer solicitation limitations may be considered overbroad, unreasonable, and, therefore, unenforceable, at least without reformation. In *Peat Marwick*, the Texas Supreme Court held that a covenant not to compete was overbroad and unenforceable. *Id.* at 388. The covenant prohibited a former partner of an accounting firm from soliciting or doing business for clients acquired by the firm during the twenty-four month period immediately after the partner left, or with whom the partner had no contact while at the firm. *Id.* at 383. For a scope of activity limitation of this type to be reasonable, there must be “a connection between the personal involvement of the former firm member [and] the client.” *Id.* at 387. Therefore, a covenant against soliciting customers should be limited to customers with whom the employee had contact during the period of employment; absent such a limitation, the covenant is overbroad. *Id.* at 388. The second, and broader scope of

whom the employee had daily contact on a personal level would likely be deemed reasonable.<sup>124</sup>

## 2. *Limitations on Time*

The duration of the restriction also determines the reasonableness of the restraint.<sup>125</sup> Restraints that are unlimited in time are almost always unreasonable.<sup>126</sup> However, it is necessary to consider the particular industry at issue to determine whether the particular restraint is reasonable as to time. The courts' inconsistent analysis under this fact-specific inquiry is frustrating. As one commentator states:

A look at the cases finds courts upholding restrictive covenants that last as long as five or ten years, while invalidating others that last only one or two years. Moreover, courts in the same jurisdiction will uphold a three-year limitation in one case but invalidate it in another. Unfortunately, in so doing the courts seldom attempt to reconcile their decisions, except perhaps by saying that each case must be decided on its own facts. In reviewing the cases, one could decide that the decisions are totally serendipitous and would not be far wrong. However, luck and good fortune are not particularly helpful when drafting clauses.<sup>127</sup>

A review of case law indicates that most courts usually uphold time limitations of one or two years.<sup>128</sup> While limitations of three to five years may be upheld in the sale of a business, the decisions conflict as to whether a three to five year limitation is reasonable in an employment situation.<sup>129</sup>

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activity limitation is one that prohibits any competitive activity. Texas courts generally uphold such limitations when the employer is engaged in only a single type of business. *See* Property Tax Assocs. v. Staffeldt, 800 S.W.2d 349, 351 (Tex. App. 1990). On the other hand, when an employer engages in a number of different types of business, such a limitation may be unreasonable unless it is limited to the specific type of business in which the employee worked while employed by the employer. *See* Diversified Hurrion Res. Group v. Levinson-Polakoff, 752 S.W.2d 8, 11 (Tex. App. 1988).

<sup>124</sup> *Peat Marwick*, 818 S.W.2d at 387.

<sup>125</sup> *McElroy*, 645 S.W.2d at 339.

<sup>126</sup> *See, e.g., Taylor v. Saurman*, 1 A. 40, 41 (Pa. 1885) (declaring covenant not to re-engage in photography void as against public policy).

<sup>127</sup> 1 KURT H. DECKER, COVENANTS NOT TO COMPETE 127 (WILEY LAW PUBLICATIONS 2d ed. 1993).

<sup>128</sup> *See id.*; *Ruscitto v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 777 F. Supp. 1349, 1354 (N.D. Tex. 1991); *Picker Int'l v. Blanton*, 756 F. Supp. 971, 982 (N.D. Tex. 1990); *McElroy*, 645 S.W.2d 338 at 339.

<sup>129</sup> Texas cases provide a representative array of decisions. *Compare* Prop. Tax Assocs., Inc. v. Staffeldt, 800 S.W.2d 349, 350 (Tex. App. 1990) ("The courts of this state have upheld restrictions ranging from two to five years as reasonable."), *and* *McElroy*, 645 S.W.2d at 339 ("Two to five years have repeatedly been held to be reasonable."), *with* *Bob Pagan Ford, Inc. v. Smith*, 638 S.W.2d 176, 178-79 (Tex. App. 1982) (upholding trial court's decision to reform the restricted period under an employment agreement from three years to six months).

### 3. *Limitations on Geography*

The geographical limitation in a noncompete agreement must be definite.<sup>130</sup> An indefinite description of the geographical area should render the agreement unenforceable as written.<sup>131</sup> Numerous courts have found that a reasonable area consists of the territory in which the employee worked while employed.<sup>132</sup> Beyond this general rule, however, what constitutes a reasonable geographical area invariably depends upon the facts of the specific case.

Traditionally, the reasonableness of a geographic limitation was directly related to the location of the territory in which the employee worked for his former employer.<sup>133</sup> Courts have found that geographic restraints were reasonable “if the area of the restraint is no broader than the territory throughout which the employee was able to establish contact with his employer’s customers during the term of his employment.”<sup>134</sup>

### 4. *The Effect of the Blue-Pencil Doctrine*

Traditionally, under the common law, courts rarely enforced unreasonable agreements in part.<sup>135</sup> An agreement made unreasonable by attempting to overextend its prohibitions would be either invalidated completely or the offending passage could be deleted pursuant to the blue-pencil doctrine.<sup>136</sup> The blue-pencil test is a “judicial standard for deciding whether to invalidate the whole contract or only the offending words.”<sup>137</sup> If the blue-pencil doctrine is strictly applied, “only the offending words are invalidated if it would be possible to delete them simply by running a blue-pencil through them, as opposed to changing, adding, or rearranging words.”<sup>138</sup> The blue-pencil doctrine is based in large part on the “understanding that there is not necessarily a sinister purpose behind an overbroad restrictive covenant.”<sup>139</sup> Courts can and do look to the good faith of the employer

<sup>130</sup> *Gomez v. Zamora*, 814 S.W.2d 114, 118 (Tex. App. 1991).

<sup>131</sup> *See Butts Retail, Inc. v. Diversifoods, Inc.*, 840 S.W.2d 770, 774 (Tex. App. 1992) (holding the language “‘metropolitan area’ of the Parkdale Mall store in Beaumont, Texas” indefinite and unenforceable); *Gomez*, 814 S.W.2d at 117-18 (holding the language “existing marketing area” and “future marketing area of the employer begun during employment” indefinite and unenforceable).

<sup>132</sup> Once again, Texas decisions provide a representative example. *See, e.g.*, *Zep Mfg. Co. v. Harthcock*, 824 S.W.2d 654, 660 (Tex. App. 1992); *Diversified Human Res. Group, Inc. v. Levinson-Polakoff*, 752 S.W.2d 8, 12 (Tex. App. 1988); *Martin v. Linen Sys. for Hosps., Inc.*, 671 S.W.2d 706, 709 (Tex. App. 1984); *Cross v. Chem-Air S., Inc.*, 648 S.W.2d 754, 757 (Tex. App. 1983).

<sup>133</sup> *See Levinson-Polakoff*, 752 S.W.2d at 12; *see also Butler v. Arrow Mirror & Glass, Inc.*, 51 S.W.3d 787, 793 (Tex. App. 2001).

<sup>134</sup> Todd M. Foss, *Texas, Covenants Not to Compete, and the Twenty-First Century: Can the Pieces Fit Together in a Dot.Com Business World*, 3 HOUS. BUS. & TAX L.J. 207, 225 (2003) (citation omitted); *see, e.g.*, *Curtis v. Ziff Energy Group, Ltd.*, 12 S.W.3d 114, 119 (Tex. App. 2000); *Evan’s World Travel, Inc. v. Adams*, 978 S.W.2d 225, 232-33 (Tex. App. 1998).

<sup>135</sup> *Garrison & Wendt*, *supra* note 99, at 117.

<sup>136</sup> *Id.* at 118-19 (footnote omitted).

<sup>137</sup> BLACK’S LAW DICTIONARY 183 (8th ed. 2004).

<sup>138</sup> *Id.*

<sup>139</sup> *Reddy v. Cmty. Health Found. of Man*, 298 S.E.2d 906, 914 (W. Va. 1982) (“In most cases, the promise is not required by the employer because he is a hardhearted oppressor of the poor. He too is

in determining whether to utilize the blue-pencil doctrine.<sup>140</sup>

Use of the blue-pencil doctrine differs from state to state. Among those states that enforce noncompete agreements, three schools of thought exist.<sup>141</sup> As the First Circuit summarized:

Courts presented with restrictive covenants containing unenforceable provisions have taken three approaches: (1) the “all or nothing” approach, which would void the restrictive covenant entirely if any part is unenforceable, (2) the “blue-pencil” approach, which enables the court to enforce the reasonable terms provided the covenant remains grammatically coherent once its unreasonable provisions are excised, and (3) the “partial enforcement” approach, which reforms and enforces the restrictive covenant to the extent it is reasonable, unless the “circumstances indicate bad faith or deliberate overreaching” on the part of the employer.<sup>142</sup>

As noted above, some states follow a “no modification” approach to noncompete agreements.<sup>143</sup> Also known as the “all-or-nothing” rule, this approach precludes the use of the blue-pencil doctrine.<sup>144</sup> Courts adhering to this approach refrain from either rewriting or striking overbroad provisions in noncompete agreements.<sup>145</sup> Courts in no-modification states first determine whether the restrictive covenant is reasonable as written.<sup>146</sup> If not, the court will not modify or eliminate provisions, but will instead refuse to enforce the agreement at all.<sup>147</sup>

The second approach is known as the strict blue-pencil rule. The strict blue-pencil rule does not allow courts to rewrite overbroad noncompete agreements.<sup>148</sup> Instead, the strict approach allows courts only to strike overbroad provisions and enforce what is left of the agreement. Enforcement is permitted only if the agreement is reasonably limited after the overbroad provisions have been removed.<sup>149</sup>

Finally, other states have adopted a liberal form of the blue-pencil doctrine: the “reasonable modification” approach. These states permit a court to rewrite an overbroad non-competition agreement to reasonably limit the restrictions found in

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engaged in the struggle for prosperity and must bend every effort to gain and to retain the good will of his customers. It is the function of the law to maintain a reasonable balance.” A.L. CORBIN, CONTRACTS § 1394 (1962)).

<sup>140</sup> See *Reddy*, 298 S.E.2d at 916 (“If the reviewing court is satisfied that the covenant is reasonable on its face, hence within the perimeter of the rule of reason, it may then proceed with analysis leading to a ‘rule of best result.’ Pursuant to that analysis, the court may narrow the covenant so that it conforms to the actual requirements of the parties.” *Id.*).

<sup>141</sup> *Ferrofluidics Corp. v. Advanced Vacuum Components, Inc.*, 968 F.2d 1463, 1469 (1st Cir. 1992) (citing *Durapin, Inc. v. Am. Prods. Inc.*, 559 A.2d 1051, 1058 (R.I. 1989)).

<sup>142</sup> *Id.*

<sup>143</sup> *Id.*

<sup>144</sup> *Id.*

<sup>145</sup> *Id.*

<sup>146</sup> *Diversified Human Res. Group, Inc. v. Levinson-Polakoff*, 752 S.W.2d 8, 12 (Tex. App. 1988).

<sup>147</sup> *Id.*

<sup>148</sup> See *Deutsche Post Global Mail, Ltd. v. Conrad*, 292 F. Supp. 2d 748, 754 (D. Md. 2003) (The strict approach is “limited to removing the offending language without supplementing or rearranging the remaining language.”).

<sup>149</sup> See *Broadway & Seymour, Inc. v. Wyatt*, 944 F.2d 900, 1991 U.S. App. LEXIS 33801 (4th Cir. N.C. 1991) (contrasting the strict North Carolina blue pencil rule with the liberal Florida approach).

the agreement.<sup>150</sup>

### *C. How to Draft a Noncompete Agreement*

A noncompete agreement can be drafted to provide a better chance of enforcement. The best thing that a drafter can do to ensure enforcement is to individualize the agreement as much as possible. The closer aligned the agreement is with the actual nature of the employee's position, the more likely it is to be enforced.<sup>151</sup>

The law will only support a noncompete agreement that is based on legitimate purposes.<sup>152</sup> As discussed above, those purposes are generally based on employer goodwill and trade secrets.<sup>153</sup> Thus, the employer should begin by looking at the employee and determining whether this employee, and this position, should be restrained. In short, an employer must ask whether a legitimate purpose is being served with a particular noncompete agreement. To ensure a greater chance of enforcement, it may be worthwhile to explicitly name the purpose being served.

Once the employer has committed to the noncompete agreement, it is best to determine how the agreement will be constrained. A noncompete agreement must be constrained in three ways: by scope of activity, by geography, and by time.<sup>154</sup>

The contractual clause limiting the scope of the employee's activity must relate to the work that the employee is actually doing, not what the employee was hired to do or what the employee could do in the future.<sup>155</sup> Because a noncompete agreement must serve a legitimate purpose, the scope of activity that the employer is seeking to restrain must be related to one of the purposes discussed above: either goodwill or trade secrets.<sup>156</sup> The noncompete agreement cannot function as a restraint only for restraint purposes – instead it is restraint to prevent unfair competition.<sup>157</sup> Thus, when drafting a noncompete agreement, the employer should review the employee's job duties. The noncompete agreement should reflect a restraint on similar duties. A noncompete agreement that stretches too far in the type of work that it seeks to limit invites a challenge.

The noncompete agreement must be limited by time.<sup>158</sup> The time period will differ depending on the interest that the noncompete agreement is protecting. If a worker in a technical field is bound by a noncompete agreement, it is much more

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<sup>150</sup> See *Bess v. Bothman*, 257 N.W. 2d 791, 794 (Minn. 1997); see also *Conrad*, 292 F. Supp. 2d at 758; *Butler v. Arrow Mirror & Glass, Inc.*, 51 S.W.3d 787, 793 (Tex. App. 2001).

<sup>151</sup> *Prop. Tax Assocs., Inc. v. Staffeldt*, 800 S.W.2d 349, 351 (Tex. App. 1990).

<sup>152</sup> *Garrison & Wendt*, *supra* note 99, at 117.

<sup>153</sup> *Id.*

<sup>154</sup> See *UARCO Inc. v. Lam*, 18 F. Supp. 2d 1116, 1121 (D. Haw. 1998) (noting parameters of reasonableness inquiry); *Pinnacle Performance, Inc. v. Hessing*, 17 P.3d 308, 311 (Idaho Ct. App. 2001).

<sup>155</sup> *Diversified Human Res. Group, Inc. v. Levinson-Polakoff*, 752 S.W.2d 8, 12 (Tex. App. 1988).

<sup>156</sup> *Garrison & Wendt*, *supra* note 99, at 116.

<sup>157</sup> *Id.* at 115-16.

<sup>158</sup> See *Taylor v. Saurman*, 1 A. 40, 41-42 (Pa. 1885).

likely that a court will view the time limit with suspicion.<sup>159</sup> Because technology changes rapidly, an agreement that seeks to restrain an employee for a long period of time will be hard-pressed to stand up in court.<sup>160</sup> If the legitimate interest being served is protection against unfair competition, a court is likely to find that binding an employee for a lengthy time does not serve that interest because technology changes quickly.<sup>161</sup>

When deciding on an appropriate time restriction, employers should carefully review the work that the employee is doing to ensure that the time limit matches the job responsibilities. Lower-level employees may be able to challenge a lengthy time restriction, while a longer time restriction would likely prove valid for upper-level employees.<sup>162</sup>

Still, how long can one restrict an employee? The answer, unfortunately, is not clear. Traditionally, courts upheld restrictions for less than two years, while viewing anything more than that very carefully.<sup>163</sup> Although there has never been a uniformly-enforced time period, the recent trend is for courts to enforce longer time limits. Recent cases have seen support for time limits over two years.<sup>164</sup> For those employers in blue-pencil states, it is worthwhile to err on the upper side of a time limit, since employers can be confident that a court interested in reformation of the agreement will simply amend the time restriction.<sup>165</sup> A court need not look very hard at time limit to lower it.

The problems with noncompete agreements are well-documented. These agreements are subject to bewildering state laws, courts that may enforce the agreement only in part or not at all, and general confusion on the part of both employer and employee.

#### *D. Drafting a Noncompete Agreement that a Court Will Enforce*

It is possible to create an agreement that is more likely to be enforced. In every state that enforces noncompete agreements, the threshold inquiry is one of reasonableness.<sup>166</sup> This reasonableness requirement is in place to ensure that the noncompete agreement extends no further than to protect the legitimate business interest that is served by the noncompete.<sup>167</sup> Having determined that such a business interest is served, the court will next conduct a reasonableness inquiry.<sup>168</sup>

The reasonableness inquiry consists of an independent analysis of three

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<sup>159</sup> Foss, *supra* note 134, at 228.

<sup>160</sup> *Id.* at 229.

<sup>161</sup> *Id.* at 227.

<sup>162</sup> Garrison & Wendt, *supra* note 99, at 121.

<sup>163</sup> See *Bob Pagan Ford, Inc. v. Smith*, 638 S.W.2d 176, 178 (Tex. App. 1982) (reducing a three year injunction to six months).

<sup>164</sup> Garrison & Wendt, *supra* note 99, at 123.

<sup>165</sup> *Id.* at 178 (citations omitted); *Deutsche Post Global Mail, Ltd. v. Conrad*, 292 F. Supp 2d 748, 754 n.3 (D. Md. 2003).

<sup>166</sup> Garrison & Wendt, *supra* note 99, at 115.

<sup>167</sup> *Pinnacle Performance, Inc. v. Hessing*, 17 P.3d 308, 311 (Idaho Ct. App. 2001).

<sup>168</sup> *Id.*

separate elements: the scope of the activity to be restricted, the geographic location in which the activity is to be restricted, and the time for which the activity is to be restricted.<sup>169</sup>

### 1. Calculating the Time Restraint

Although rarely acknowledged expressly, it is the time element that a court will examine first.<sup>170</sup> Such placement in the chain of analysis is logical. An examination of the time requirement can be made quickly, requiring very little work on behalf of the court. A review of case law reveals that certain bounds are essentially predetermined, no matter what the scope or geography limitation. A time period of five years is unlikely to be upheld,<sup>171</sup> but a court will likely view a time period of a year or less as reasonable.<sup>172</sup>

From a strategic viewpoint, consider the value of the particular employee, the importance of the position to the company, and the reason why this employee's work for a competitor would either provide an unfair advantage to a competitor or damage the goodwill of the company. An employer should seek to restrain an employee only to the extent outlined, or risk having the agreement fail completely or reformed by the court.<sup>173</sup>

### 2. Calculating the Scope of Activity Restraint

Having made a decision as to the time in which the employee is to be restrained, the employer should look at what activities are to be restrained. Remember that the purpose of the noncompete is to prevent unfair competition.<sup>174</sup> For that reason, the scope of the activity to be restrained should resemble the scope of the employee's current position. An employer can determine this first by looking at the job description for the employee's current position. This job description should accurately describe what it is that the employee does. The proposed noncompete agreement should describe with some particularity the activities the employee is restrained from performing. The key is specificity; a court is more likely to enforce an agreement if it can readily determine that the provisions are not mere boilerplate.

The scope of activity limitation raises another issue. A noncompete agreement should be updated if the employee's position or responsibilities change. It is not uncommon for an employee's responsibilities to grow over time; often an employee will begin work for a firm and then be promoted within the organization. At the time of the employee's separation from the organization, the job

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<sup>169</sup> *Id.*

<sup>170</sup> *Prop. Tax Assocs. v. Staffeldt*, 800 S.W.2d 349, 350 (Tex. App. 1990) (examining the reasonableness of the agreement's time limitation first).

<sup>171</sup> *Investors Diversified Servs., Inc. v. McElroy*, 645 S.W.2d 338, 339 (Tex. App. 1982) (noting that two to five year restraints have repeatedly been held as reasonable).

<sup>172</sup> *Picker Int'l v. Blanton*, 756 F. Supp. 971, 982 (N.D. Tex. 1990).

<sup>173</sup> *See Staffeldt*, 800 S.W.2d at 351.

<sup>174</sup> *Garrison & Wendt*, *supra* note 99, at 115-16.



responsibilities may far exceed those that existed when the employee started. An employer should expect that an employee's noncompete agreement will change during the course of his career.

This need to modify an agreement over time should not pose a significant burden on the employer. One can presume that as new pay and benefit packages are prepared, an opportune time to revisit the noncompete agreement arises. It is also advisable to discuss, at the time of signing, that execution of a revised noncompete agreement is a normal part of the company's employee retention scheme. Assumedly, an employee is less likely to balk at the noncompete agreement when it is presented in conjunction with a promotion, increased salary, or other similar items.

### 3. Drafting the Geographic Restraint

Having conquered the first two hurdles, only the question of the noncompete agreement's geographic restraint remains. This restraint, once so easily understood by courts, employers, and employees, has also grown much more problematic in recent years. The geographic limitation was originally aimed at preventing unfair competition in the area in which the employer did business.<sup>175</sup> In recent years, the geographic ranges of businesses have expanded tremendously.<sup>176</sup> Organizations that at one time might have limited themselves to a customer base living within ten square miles of the business are now doing business throughout the state, across the nation, and worldwide.<sup>177</sup> Salesmen who might once have limited themselves to a three county area are now able to peddle their goods to customers regardless of their location.<sup>178</sup>

This growth in geographic sales range is not merely the result of the Internet. Barriers to commerce have increasingly shrunk, with the advent of inexpensive telephone service, and other technological advances. In any event, one can easily suppose that the business range of most companies has expanded greatly within the last decade.

Despite these advances, employers have benefitted from the opinion of some courts that geographic location need not be enforced quite as strongly as the other requirements.<sup>179</sup> Nationwide bans have been upheld; even worldwide restrictions have been considered valid.<sup>180</sup>

What then should we make of the geographic component of the noncompete agreement? As a result of these decisions, to what extent should an employer attempt to restrain the geographic range of its ex-employees? The starting point should again be the nature of the employee's current position. In what geographic region does the employee currently work? What is the actual market for the company's products? One may argue that, because a company sells products on

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<sup>175</sup> *Evan's World Travel, Inc. v. Adams*, 978 S.W.2d 225, 232-33 (Tex. App. 1998).

<sup>176</sup> Foss, *supra* note 134, at 225.

<sup>177</sup> *Id.* at 225-26.

<sup>178</sup> *Id.*

<sup>179</sup> *Id.* at 227.

<sup>180</sup> *Id.* at 228 (citation omitted).

the web, it has a worldwide scope. However, courts will not likely accept such an argument without evidence to establish that a percentage of a company's products are actually sold worldwide.

*E. Drafting a Noncompete Agreement that the Employee Will Sign*

An employer should have two elements in mind when drafting a noncompete agreement: drafting an agreement that a court will enforce and drafting an agreement that will not anger or alienate the employee. For this reason, employers should simply include noncompete agreements as a regular part of employee retention strategy.

The employee who is being rewarded with a high quality workplace, regular promotions, and the opportunity for pay increases is more likely to understand that a noncompete agreement is a natural and normal part of the employment relationship. The noncompete agreement should neither be presented in an adversarial sense nor as something that "human resources" or "the general counsel" requires the employee to sign. Instead, by including noncompete agreements as a regular part of the employer's employee retention strategy, an employer dulls the edge of what could otherwise be a contentious document.

## V. CONCLUSION

Recently, employers have embraced the human capital theory and have altered their view of employees. Employers recognize that their employees are a valuable asset of the organization. Human capital is just as real, and just as important, as physical assets. At the same time, companies must acknowledge that investment in its human capital, in its employees, leads to a paradox.

A company that invests in its employees by providing those employees with new skills and knowledge, finds that it has increased the employee's value. It also discovers that the employee has gained skills and knowledge that will enhance the employee's mobility. The more investment a company makes in its employees, the higher the risk that the employee will transfer the benefits of the organization's investment to a competitor.

Organizations must seek a way to secure that investment. To preserve its investment in human capital, management needs to understand employment law. Understanding employment law, and its relationship to the preservation of human capital, requires the management team to consult with attorneys. The law provides several tools to manage the employment relationship. The tool most readily applied to the preservation and retention of an organization's human capital is the noncompete agreement. A noncompete agreement, carefully drafted and tailored to the employee's situation, will help firms retain the benefit of their investment in their workforce.