High Unemployment May Threaten Restrictive Covenants

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The employment lawyer's stock in trade is the restrictive covenant. Noncompete, nonsolicitation and trade secret protections find their way into a meaningful number of employment agreements across virtually all business sectors.

With the COVID-19 pandemic generating record levels of unemployment, changes may be on the horizon for the enforceability of such covenants.

Whether and how states enforce restrictive covenants is driven by how they view these restrictions as a matter of public policy. The dueling considerations that drive these policy considerations are well known — they protect the legitimate business interests of employers at the expense of the freedom of employees to join a new employer or to start a competing business.

In practice, by increasing the real costs to employees of switching jobs and thereby decreasing what employers need to pay to retain talent, restrictive covenants may also depress wages. Three states — California, North Dakota and Oklahoma — have weighed these competing interests and determined that noncompetes generally should not be enforced.

Several other states prohibit their enforcement against low-wage workers or in certain professions, such as physicians. In the majority of states, New York included, the standard is more flexible. There, noncompetes and nonsolicits are legally valid to the extent that they are tailored to protect an employer's business concerns, with the devil in the details.

We have grown accustomed to these familiar frameworks. However, they are familiar because they are old. Each framework was erected decades earlier and under conditions that do not approximate the dramatic impact that COVID-19 is having on the economy.

No doubt the pandemic is hurting both employers and workers. But the impact on workers magnifies the harm that restrictive covenants inflict on employee mobility and wages, thereby undermining the policy balance each state has struck.

As a result, courts, regulators and policymakers are likely going to be more sympathetic to workers — even those that have jobs and are merely constrained by noncompetes and nonsolicits — if large numbers of persons are out of work.

On this point, the numbers are instructive. When the two seminal cases establishing the New York framework for restrictive covenants were decided over 20 years ago,[1] unemployment was 4.2%.

Both before and after those decisions, the unemployment rate fluctuated within a relatively narrow range: The annual unemployment rate over that period exceeded 8% only four times — 2009 to 2012.[2] By comparison, after skyrocketing to 14.7% in April 2020, the unemployment rate fell to a still astronomical 13.3% in May.[3]

On June 10, the Federal Reserve System predicted that the nominal unemployment rate for 2020 would be 9.3%.[4] Irrespective of whether that projection turns out to be optimistic or pessimistic, historically high unemployment during the pandemic and its aftermath appears to be a certainty.

What legal changes can employment lawyers expect if the economy fails to rebound in a V-shaped pattern and high unemployment persists? The easy answer is that there will be greater scrutiny of restrictive covenants and their impact on employees.

As explained below, however, what that scrutiny will entail in practice depends on the policy justification for the noncompete or nonsolicit.

Protection of Trade Secrets

Restrictive covenants shield employers from the danger that a competitor will hire an employee to obtain access to trade secrets and other proprietary information that have been shared with the employee.

To the extent that an employer has what a court would consider to be novel trade secrets, such as scientific data or technical know-how, a noncompete safeguarding that information should remain enforceable regardless of future economic conditions.

In such situations, not only is the employer's business interest clear, but the employer's investment in creating that interest cannot be contested. To invalidate a noncompete protecting the trade secret would potentially award the employee or future employer a windfall at the employer's expense.

The same is not necessarily true for other types of proprietary information. While customer data, marketing plans and business strategies are all business interests deserving of protection, they are less likely to be impacted by a single employee's departure, particularly since other provisions in the employee's contract will almost certainly prohibit them from taking any documents when they leave.

This type of nontechnical data also tends to become stale as market conditions change and client interests shift. Accordingly, in a high unemployment environment, lengthy restrictive covenants covering marketing and sales personnel could easily be deemed unenforceable by courts or, in the case of entry-level staff, inappropriate by regulators.

Client Relationships and Goodwill

While customer relationships and goodwill are valuable business assets that can be protected by restrictive covenants, the company's interest in them also wanes over time.

Consider an electronic discovery vendor that services a law firm. The salesperson that recruited the law firm or was given the law firm account has acquired goodwill with his or her contact that was developed at the employer's expense.

But that goodwill should not render the law firm immune from competition by the departing salesperson or the new employer forever; at a certain point, it is the responsibility of the vendor either to secure support of the law firm anew or to outperform any competitor the salesperson might join.

The question is where to draw the line for enforceability of the restrictive covenant. The case law provides no clear guidance, as some courts have found one-year noncompetes to be unduly onerous, while others have found two-year noncompetes to be enforceable.[5]

In a high-unemployment environment, the line is likely to be drawn in a way that is favorable to the employee. Employers should not reasonably expect restrictive covenants protecting customer relationships greater than one year in duration to be found valid in the event that the pendulum shifts against enforceability.

Unique and Extraordinary Employees

Restrictive covenants also protect an employer's interest in unique and extraordinary employees, who are irreplaceable and the loss of which would cause a special harm to the employer. This goes beyond the particular employee's access to confidential information or client relationships; they are uniquely skilled or knowledgeable in some way.

This justification for restrictive covenants is perhaps the most vulnerable in a high-unemployment environment. By definition, there is a social cost to causing employees who have truly extraordinary skills to sit on the sidelines until restrictive covenants expire, as those are the persons who arguably most need to be employed when the economy is suffering.

Moreover, what makes these persons irreplaceable may have nothing to do with investments made by the employer. A respected cancer researcher is highly valuable to a health care technology company, but that is only because the researcher spent years acquiring specialized knowledge. It would be unfair to penalize the cancer researcher for the time, effort and money that went into obtaining that knowledge.[6]

There are myriad ways that employers can protect themselves from the departure of unique and extraordinary employees that go beyond simple restrictive covenants.

For example, an employer can defer compensation that the employee forfeits upon departure or award the employee options that vest only if the employee remains with the company. Likewise, employers can bind employees with paid notice periods or term contracts.

While these options may be more costly to employers in terms of money and flexibility, they should be considered as a way to ensure the continued loyalty of key personnel.

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[1] See Ticor Title Ins. Co. v. Cohen, 173 F.3d 63 (2d Cir. 1999); BDO Seidman v. Hirshberg, 93 N.Y.2d 382, 712 N.E.2d 1220 (N.Y. 1999).

[2] https://www.statista.com/statistics/193290/unemployment-rate-in-the-usa-since-1990/.

[3] https://www.bls.gov/news.release/empsit.nr0.htm.

[4] https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20200610.htm.

[5] Compare Veramark Techs., Inc. v. Bouk, 10 F. Supp. 3d 395, 406 (W.D.N.Y. 2014); Locke v. Tom James Co., 2013 WL 1340841, at *9 (S.D.N.Y. Mar. 25, 2013).

[6] See, e.g., Flatiron Health, Inc. v. Carson, 2020 WL 1320867, at *21 (S.D.N.Y. Mar. 20, 2020) ("To equip himself to improve the outcomes of cancer patients on a large scale through the use of data analytics, [the employee] pursued both a medical degree and Ph.D. in Health Policy and Administration. Obtaining those degrees required the investment of substantial time, effort, and money.").