Are Noncompetes With Independent Contractors Enforceable?

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Employers have been focused on the distinction between employees and independent contractors of late. The classification considers numerous factors and comes with it serious consequences. An incorrect decision to label a worker as an independent contractor could result in significant liability.

An area that has received less attention is the impact of classifying a worker as an independent contractor to a noncompetition agreement (noncompete). Will the noncompete be enforceable against the independent contractor?

The 8th Circuit recently addressed this question in Ag Spectrum Co. v. Elder.[1] In that case, Ag Spectrum contracted with Vaughn Elder to work as an independent contractor and entered into a three-year noncompete agreement.

Ag Spectrum Co. v. Elder

Elder worked for Ag Spectrum selling fertilizer, nutrients and crop-management services. He sold only Ag Spectrum products in exchange for a 1 percent loyalty payment every five years.

Elder supplied his work materials at his own expense. He was not an employee for tax purposes. He was prohibited from participating in Ag Spectrum's employee benefit plan, and was not covered by Ag Spectrum's workers' compensation policy.

He had no authority to contract on Ag Spectrum's behalf. He handled the Ag Spectrum product as he saw fit, ordering, unloading, managing and paying for it.

He stored the product at his own warehouse, and a railroad tank facility owned by Ag Spectrum and operated by Elder. The product was delivered from the warehouse, railroad tank facility, and other out-of-state manufacturers and storage facilities not owned by Ag Spectrum.

Elder reported the sales to Ag Sprectrum by disclosing any changes in inventory. Elder then had to pay Ag Spectrum within 10 to 14 days and pocketed any profit on the difference between what he paid for the product and what he sold it for. If a customer did not pay, the loss fell on Elder.

Elder and Ag Spectrum had formalized his agreement in 2005, and agreed to a three-year

noncompete. Elder would not compete with Ag Spectrum by "marketing to, selling to, or consulting with its customers about similar products for three years after terminating the Agreement."

Elder terminated the agreement in 2012 and soon thereafter began competing with Ag Spectrum. In January 2015, Ag Spectrum sued him for breach of the noncompete with approximately nine months remaining on the noncompete.

Elder testified that "virtually all" of the customers that he was selling to were his customers that he had developed through his own efforts over the course of many years. Only two of the customers came to him through Ag Spectrum.

Elder argued that the agreement was unenforceable under Iowa law. He argued that because he was an independent contractor the noncompete was unenforceable per se. The district court granted Elder summary judgment on this basis, and Ag Spectrum appealed.

The 8th Circuit affirmed but on an alternative basis. The noncompete was not unenforceable per se but it was unreasonable under the circumstances.

Under Iowa law (and the law in many other jurisdictions,) a noncompete is only enforceable if it is "reasonable." In making this determination, the court performed a balancing test weighing the benefits and burdens of the noncompete, concluding that the noncompete was unreasonable and unenforceable.

The noncompete was not necessary to protect Ag Spectrum's business interests. Elder did not have an "advantage" over Ag Spectrum as a result of confidential information or training provided by Ag Spectrum that would allow him "to unfairly compete against Ag Spectrum." Ag Spectrum only provided minimum support to Elder as he merely "bought Ag Spectrum product and sold it at a markup."

Elder also did not benefit from Ag Spectrum's goodwill. The customers were his customers, and he connected them to "Ag Spectrum–not the other way around."

The burdens of the noncompete on Elder were also out of proportion with the benefit to Ag Spectrum. Elder had built his customer base, and if the court enforced the noncompete he would have to build a new customer base from "scratch." Ag Spectrum suggested that he could sell noncompeting products, but the court refused to impose such "workarounds" because Ag Spectrum had "little protectable benefit" in the relationship.

Key Takeaways

Elder is an important case for employers. It provides a framework for the type of analysis a court will undertake in determining the enforceability of a noncompete against an independent contractor

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Importantly, the court did not apply a per se rule holding that all noncompete agreements with independent contractors are unenforceable. Rather, the noncompete agreement was unenforceable under the circumstances. The employer had "little protectable benefit" because the independent contractor had developed his customer base himself and was simply selling the company's product to those customers at a markup.

It takes little imagination to envision different circumstances. What if an independent contractor was hired to service an employer's customer base? What if the employer provided the independent contractor with a customer list? What if the independent contractor had access to other confidential information from the employer? What if the independent contractor misappropriated the confidential information? What if the independent contractor held himself out to the customers as affiliated with the employer?

Employers who are considering whether to enter into a noncompete with an independent contractor may want to consider these factors and others: How much confidential information will the independent contractor have access to? Will the contractor interact with the customer base? Who developed those customers? Who is responsible for maintaining those relationships? Did the employer expend significant resources on the independent contractor such as sophisticated training on the employers' business model?

These types of questions will naturally lead the employer to consider the level of protection they legitimately need. Is a full-blown noncompete necessary or will a well-drafted nonsolicit or nondisclosure agreement sufficiently protect the business interests?

Finally, companies will want to consider and then reconsider whether the independent contractor is properly classified in the first place. Many of the factors that might lead a court to enforcing a noncompete may also weigh against the worker being classified as an independent contractor. This creates a predicament for the employer.

It might win a "battle" but lose the "war." For instance, if a worker was misclassified as an independent contractor, the employer could be successful in enforcing the noncompete, but face misclassification counterclaims from the worker for violations of state and federal wage laws. A successful counterclaim would result in damages, penalties and attorneys' fees, and may expose the employer to additional liability from other workers if they are similarly misclassified.

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