What Every North Carolina Employer Needs to Know About Restrictive Workplace Covenants (Part 1)

Insights
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Employers across North Carolina invest a lot of time and money in their employees and their customers. As part of that investment, companies often provide employees with confidential information and entrust them to interact directly with customers – including asking them to nurture goodwill with existing customers and develop new customer relationships. Those customer relationships are integral to a company's continued success. Naturally, you want to protect not only the confidential information and goodwill that employees have learned and created, but the customer relationship itself. To ensure this confidential information and goodwill are protected, North Carolina employers often resort to using agreements that contain restrictive covenants to limit what employees can and cannot do during or at the end of their employment. These restrictive covenants include non-disclosure, non-competition, non-recruitment, and non-solicitation provisions, and appear in a variety of different manners. This Insight is part of a three-part series aimed at discussing the parameters of restrictive covenant agreements in North Carolina. The first Insight will discuss the **general enforceability and scope** of restrictive covenant agreements. The second installation will cover issues arising when **entering into restrictive covenants**. The third and final installment will discuss restrictive covenant considerations at **the end of an employee's employment**.

Why Use Restrictive Covenants?

Restrictive covenants can be viewed generally from both an employer's and employee's viewpoint. From an employer's viewpoint, restrictive covenants safeguard a business's interests, including its confidential or proprietary business information, its relationships with its current and prospective customers and vendors, its relationships with its employees, or its position in the competitive marketplace. In this way, restrictive covenants prohibit employees from taking that information or goodwill for their own benefit or for the benefit of a competing company. From an employee's viewpoint, restrictive covenants potentially inhibit their ability to move positions in the marketplace and take with them a book of business they developed over the course of their employment.

Types of Restrictive Covenants

There are various types of restrictive covenants, including non-disclosure, non-competition, non-recruitment, and non-solicitation covenants.

- A **non-disclosure covenant** protects your confidential information (i.e., trade secrets, customer lists, sales and marketing plans, financial data), prohibits an employee from divulging your confidential information during or after employment, and restricts the use or disclosure of confidential information after employment. For example, if a departing employee is leaving to work for a competitor, a non-disclosure covenant would restrict that individual's ability to use or disclose the employer's confidential information in his new job.
- A **non-compete agreement** restricts an employee's ability to compete with the employer during or after termination of employment. For example, a departing employee may be prohibited from working for a competitor to the employer in a similar job function.
- A **non-recruitment covenant** protects an employer's relationships with its own employees and prevents a departing employee from soliciting other employees to leave the employer and work elsewhere. For example, if the departing employee is leaving to open a new business, that departing employee cannot solicit co-workers to leave to join the new business. Sometimes, non-recruitment covenants are also referred to as non-solicitation covenants.
- A **non-solicitation covenant** protects an employer's relationships and goodwill with customers, prospective customer, or other outside or third-party entities, such as vendors, against misappropriation by a departing employee and prevents that employee from soliciting customers to other outside entities to alter or end their relationship with the employer. For example, a departing employee may be prohibited from soliciting a customer of the employer with whom the employee worked to enter a business relationship at the individual's new venture..

Is There an Applicable North Carolina Statute?

North Carolina is one of the few states in the country that has a specific statute that touches upon restrictive covenants. Specifically, N.C. Gen. Stat. § 75-4 provides:

> No contract or agreement hereafter made, limiting the rights of any person to do business anywhere in the State of North Carolina shall be enforceable unless such agreement is in writing duly signed by the party who agrees not to enter into any such business within such territory: Provided, nothing herein shall be construed to legalize any contract or agreement not to enter into business in the State of North Carolina, or at any point in the State of North Carolina, which contract is now illegal, or which contract is made illegal by any other section of this Chapter.

The statute does not bar "limiting the rights of any person to do business" (i.e., a non-competition provision), but requires that any agreement containing a non-competition provision must be in writing. While this statute provides some direction, the applicable law for restrictive covenants comes from court decisions in North Carolina.

What Are the Elements of Restrictive Covenants?

North Carolina courts have developed a legal framework for restrictive covenants. Due to the nature of these covenants, you need to tailor employment agreements carefully to ensure that any restrictions comply with North Carolina law to avoid an unfavorable decision in court. The benchmark for restrictive covenant agreements in North Carolina is reasonableness.

Generally, in order to have an enforceable restrictive covenant agreement, the restraints need to be:

1. in writing;
2. part of a contract of employment or sale of the business;
3. based on valuable consideration;
4. reasonably necessary for the protection a legitimate business interest; and
5. reasonable as to time and territory.

In addition to these factors, courts may also review public policy considerations to determine whether a restrictive covenant is reasonable. The type of covenant dictates the factors to be considered and the level of scrutiny applied by the court. All of the factors identified above may or may not apply to a particular situation and agreement. As indicated by the second factor, restrictive covenants typically appear in two situations: in agreements with individual employees and in agreements for the sale of a business.

The first two factors (in writing and as part of an agreement or the sale of a business) are straightforward. The third through fifth factors are typically where employers may encounter trouble if their agreements are not adequately tailored to their business and within the parameters identified by North Carolina case law.

"*Based on Valuable Consideration"*

Under the third factor – "based on valuable consideration" – there should be an exchange of some benefit, whether it is the offer of new employment, payment, or other bargained-for exchange. The appropriate consideration varies based on the nature of the business and employment relationship. In North Carolina, the case law varies widely regarding appropriate consideration. These circumstances, and the third factor more generally, will be addressed in the second installment of this three-part series when discussing entering into restrictive covenant agreements.

"Reasonably Necessary to Protect a Legitimate Business Interest"

The fourth factor requires that a restrictive covenant be reasonably necessary to protect a legitimate business interest. These interests include, for example, confidential information and customer goodwill. The protection of customer relations against misappropriation by a departing employee is recognized as a legitimate interest of an employer, assuming there is actually protectable goodwill. Similarly, the protection of confidential information, to a certain extent, is also recognized as a

legitimate interest of an employer. But you must be careful not to overextend the terms of the restrictive covenant. If you define "customers" or "confidential information" too broadly, the provision may be deemed unreasonable and unenforceable.

"Reasonable as to Time and Territory"

As for the last factor – reasonableness as to time and territory – courts in North Carolina have held one-, two-, and three-year time restrictions reasonable under particular circumstances, and noted that five years is on the outer boundary of reasonableness. In the sale of a business context, the timeframe can be extended under certain circumstances.

Territory is typically considered regarding non-competition covenants rather than non-disclosure, non-recruitment, or non-solicitation covenants. For non-competition covenants, courts typically review time and geographic limitations in tandem. A longer period of time for a restriction may be acceptable if the geographic restriction is relatively small, and vice versa. The time and geographic limitations should not be any greater than reasonably necessary.

In determining whether the geographic scope is reasonable, courts have reviewed: (1) the area, or scope, of the restriction; (2) the area assigned to the employee; (3) the area where the employee actually worked or was subject to work; (4) the area in which the employer operated; (5) the nature of the business involved; and (6) the nature of the employee's duty and his knowledge of the employer's business operation. The nature of your business drives the considerations for whether the amount of time and geographic region are reasonable. The scope of time and geographic area should not be any wider than is necessary to protect an employer's business interests.

For non-recruitment and non-solicitation covenants, you may specifically restrict identified employees or customers that a departing employee may not recruit or solicit for a certain period of time. These restrictions are also considered for general reasonableness taking into consideration many of the same factors. For non-solicitation covenants, there are varying methods for identifying the customers, and you should be particularly careful not to include an overbroad definition. There are many pitfalls that you may encounter when you define your customer base that could render a restriction overbroad and unreasonable, and as a result, potentially unenforceable.

Finally, for non-disclosure covenants, courts often enforce much longer restrictions on disclosing confidential information. Restrictions can at times be indefinite depending on the nature of the information.

Parting Considerations

There are many nuances to restrictive covenant agreements in North Carolina. One size does not fit all. The general principles identified above may or may not apply to each situation. Instead, based on the unique facts of every case, there may be differing considerations that apply to restrictive covenant agreements.

The key, as always, is that your restrictive covenant agreements need to be properly drafted. In North Carolina, courts are permitted to "blue pencil" restrictive covenants. This means that a court may decide not to enforce a part of the covenant that is *distinctly separable* in order to make the provision reasonable. However, a court is not able to re-draft an overly broad provision completely or from scratch. The court will strike through the unenforceable language and if the agreement reads coherently without that language, the court may enforce it. Ideally, a properly drafted restrictive covenant agreement will not have to rely on blue penciling.

It is important to remember that all states review restrictive covenant agreements differently. Some states completely ban types of restrictive covenants while other states allow certain covenants, but only with specific language included in the agreement. Restrictive covenant agreements should be written to be lawful in the state where the employees lives and/or works.

Attorneys at Fisher Phillips can assist you in drafting restrictive covenant agreements in North Carolina and throughout the United States. If you are interested in adopting restrictive covenants, or need your current employment agreements reviewed, please contact your Fisher Phillips attorney, the authors of this Insight, or any member of our Employee Defection and Trade Secrets Practice Group. Ensure you are subscribed to Fisher Phillips' Insight System to get the most up-to-date information and to receive the next two editions of this three-part series.

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