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Drafting Covenants Not to Compete to Maximize the Likelihood of Enforcement

Article By:

Lee A. Spinks

In the last issue, we reviewed the basic rules applicable to covenants not to compete in employment contracts. Lawyers experienced in dealing with these covenants have adopted a number of drafting techniques to address the many decisions of our appellate courts that raise issues regarding enforceability. The following are just a few of these techniques that a hospital, medical practice, or other health care entity may want to consider to increase the likelihood that a covenant not to compete will be the valuable, enforceable tool intended.

1. Describe the scope of the activities prohibited in a manner that anticipates changes in an employee's job responsibilities. Even the best employers often overlook updating employment contracts and covenants not to compete (as employees are promoted or their job responsibilities change). Therefore, when describing the activities that the employee will be prohibited from engaging in, the description should not be limited to his or her current job responsibilities. Include a provision that the covenant will also apply to prohibit other activities that the employee is materially involved in or exposed to during the term of employment. In doing so, the prohibition on competition should apply to those activities that the employee engaged in only during a limited period of time preceding the application of the covenant. For example, if an employee was in HR initially, but then assigned to manage claims for five years, it is unlikely that the covenant could prevent the employee from providing HR services for a competitor, because the exposure of that employee to the employer's HR section is too remote in time).

2. Draft covenants to take advantage of the "blue pencil" rule. In North Carolina, the courts will not rewrite a portion of a covenant that is overly broad or otherwise unenforceable. Instead, the court will blue pencil or strike out the unenforceable provision and enforce only what is left. Consider the health care system with locations throughout the southeastern United States that employs a manager for a three-county region of North Carolina. Because a court might determine applying the covenant to prevent the employee from taking a competitive position in all the southeastern states is overly broad and could strike that territory, the experienced attorney will describe the territory through a series of ever- increasing areas. For example, the territory could be described as (a) the three counties in which the manager is being physically employed; (b) each other county where the manager is assigned management responsibilities in the future; (c) each county that is contiguous to any of the counties in (a) or (b); (d) a 75-mile radius of each business location in which the employee has management responsibility; (e) the state of North Carolina; and then, (f) a list of each other state where the employer has locations. This allows the covenant to adapt itself to the job responsibilities of the employee as they change over time, and allows the court to strike overly broad territories while retaining smaller territory descriptions to enforce. If, for example, that employee's responsibilities remain primarily limited to the three counties for which he or she was originally employed, and the evidence does not show significant involvement in activities throughout North Carolina or exposure to trade secret or other confidential information regarding statewide activities, then a court can blue pencil the statewide and the larger territories; it will almost surely enforce the covenant for the counties in which that employee's responsibilities were primarily performed; and may or it may not enforce the covenant as to contiguous counties or the 75-mile radius, depending on a factual examination of the effects of competition actually occurring from those areas, the scope of the employee's responsibilities, and his or her involvement in activities in those broader territories. If the defined territory had only stated "the state of North Carolina." the blue pencil rule could result in that territory being stricken, leaving no smaller territorial description within which the covenant would be enforced. On the other hand, if that employee is a valuable manager, and becomes involved in many aspects of the employer's activities throughout the state or the Southeast, by using this stair-step description of broadening territories, the covenant adapts itself accordingly.

This same technique can be used for other aspects of the covenant. A covenant can be designed to apply for two years to a smaller territory, but only one year to a broader territory, to increase the likelihood that the court will not find the broader territory overly broad – given the duration of the covenant is shorter. Similarly, the blue pencil rule makes it more important to define the pro hibited activities (those that the employee may not engage in for a competitor) by use of a "laundry list," with the caveat that the laundry list items apply only to the extent the employee actually becomes involved in those during his or her employment with the employer. For a physician employee of an orthopedic group, for example, rather than using a covenant to prevent his or her practice "of medicine" for a competitor – where the employee might later argue that this is overly broad – provide instead that the physician is restricted from competing "in the practice of medicine, and com peting in each aspect of the practice of medicine in which he or she engages as an employee of employer, including but not limited to, orthopedic surgery, orthopedic medicine, pain management, and rehabilitative medicine."

3. Provide for liquidated damages. The obvious and most important remedy for an employer when a former employee violates a covenant not to compete is to obtain a temporary restraining order and a preliminary injunction as quickly as possible, because it is impossible to accurately determine all the damages that will be incurred if the former employee is allowed to continue to compete. But because those damages are difficult if not impossible to fully calculate, it is also important to provide for liquidated damages. By definition, liquidated damages are a specified amount that are to be awarded in lieu of trying to determine the actual damages. To be enforceable, liquidated damages must be reasonable, basedupon reasonable assumptions of what the damages could or would likely be, and cannot be so excessive as to be punitive in nature. The liquidated damages provision could provide for an initial larger amount for the first month a violation occurs (under the assump tion that the initial violation may involve disclosures of trade secrets, interference with the employer's goodwill, or other damages that are initially substantial and will not be remedied even if a temporary restraining order or preliminary injunction is quickly entered), with a smaller fixed amount for each month thereafter that the violations continue. There are many variations to liquidated damages provisions, some of which do not involve specified dollar amounts, but instead call for the application of a formula by which damages are calculated using known or ascertainable economic factors (such as a percentage of the last twelve months of collections before termination for a physician who has departed and is now competing, or a percentage of the physician's collections derived from the period he or she violated the covenant). Some employers also use a clause that permits an employee to "buy out" of the covenant if the employee pays a significant lump sum up front before competing – an amount that fairly compensates the employer for anticipated lost income (much like the liquidated damages clause), but does provide an option by which an employee can leave and compete without relocating.

4. Consider an "overhead recovery" clause. It is particularly relevant to medical practices because, as they add physicians, they also add space, equipment, staff, and computer and billing capacity. They generally will also incur similar overhead expenses. The hiring cycle for physicians is somewhat unique – medical practicesfind it difficult to immediately replace a departing physician and may often look to residency programs, where they interview and make offers as long as a year or more before the physician being employed has completed his or her residency, passed the medical boards, and become licensed in the state of the employer. In North Carolina, an employer in such a situation can include a provision by which an employee whose employment terminates can be required to pay to the employer either a specified dollar amount or an amount that can be determined with certainty based upon a formula. This will help to compensate the employer for the lost contribution to overhead that would have otherwise been made by that employee through the collections for services he or she rendered. In practical application, many employers choose to add a provision stating that the employer will waive recovery of the lost overhead amount if the employee is retiring, is disabled, dies, or is terminated by the employer without cause. Many also use this clause to "buy time" to bring in a replacement and retain the patients and revenues that could otherwise be lost to the departing physician, by also providing that the employer waives the lost overhead amount if the former employee does not resume the practice of medicine in a specified area for two years after termination of employment. This final waiver makes it less likely that new potential employeed would decline the employment out of concern that they would be unhappy in the position and would have to pay a significant amount in order to leave, as they are assured they could leave and practice elsewhere (outside of the prescribed territory) without making the payment. The provision, written in this manner, is technically not a covenant not to compete, but it adds incentive for a departing physician not to challenge the covenant, and adds a second "tier" for recovery of damages if the former physician employee does compete.

5. *Use a "fail-safe" clause.* Health care employers, whether they be medical practices, hospital systems, or other health care providers, invest a signifi cant amount in creating the setting within which the physician, the manager, or other employee will conduct his or her business upon being hired. The employer who relies upon covenants not to compete to protect that investment from immediate competition by a former employee places great value in the covenants not tocompete. But courts can be inconsistent in their enforcement of covenants. This has led to the use of "fail-safe" clauses that are intended to recognize the value that both parties assign to the covenants. In essence, these clauses provide that both parties –employer and employee – intended at the outset that the covenants not to compete would be enforceable, and that the enforceability of those covenants was of significant consideration to the employer, inducing the employer to hire the employee. Therefore, if for any reason a court does not enforce a covenant not to compete in accordance with its terms, the employee agrees in the contract that the employer has not gotten all the consideration that was bargained for if the covenants not to compete are not enforceable, and in that event the employee owes to the employer a specified sum of money to make up for the lost consideration resulting from the covenants not being enforced. That sum of money often is similar or identical to the liquidated damages that would be owed if the covenant were to be enforced. These clauses have been used a number of times, and rarely does a departing employee elect to challenge the covenants not to compete when a fail-safe clause has also been used. The reason is obvious: such a clause essen tially says, "If the employer wins, the employee loses; but if the employee wins and the covenant is declared unenforceable, the employee still loses, because now he or she has to pay a significant amount to the employer." Until there is a definitive decision by appellate courts on the enforceability of the "fail-safe" clauses, it is impossible to predict whether they will be enforced,

but in the meantime it serves as a substantial deterrent to challenges against enforceability of covenants not to compete.

6. *Include attorney fee provision.* Until recently, an employer was not entitled to recover reasonable attorney fees incurred in the enforcement of covenants not to compete, because North Carolina statutes did not include that type of contract claim as one for which attorney fees could be recovered. Now, under recent legislation, an attorney fee provision in an employment agreement can be enforced in the context of the enforcement of covenants not to compete if the provision also provides that the employee can recover his or her attorney fees if the employee prevails. Litigation involving covenants not to compete is expensive – a great deal of fact gathering, witness interviews, preparation for hearings,drafting of pleadings, motions and briefs, and court appearances must occur in a matter of days or weeks in order to quickly pursue a claim and obtain an injunction to stop the violation of the covenants. If the employer has a valid claim, it can only recover its attorney fees by including such a provision in the contract, and doing so may be a further deterrent to the former employee pursuing competition in violation of the covenant who would then face the prospect of having to pay substantial attorney fees not only to his or her lawyer, but also to the employer's lawyer.

There are many other "tricks of the trade" in drafting enforceable covenants not to compete and similar covenants to protect an employer from damages to its goodwill, its trade secrets, and its remaining work-force. The expenses of having good covenants are really quite small when compared with the damage that can be caused by a former employee competing next door to the employer, hiring away other key employees, and making use of information and patient or customer relationships that are invaluable to the employer. This is particularly true in the increasingly competitive environment in which health care providers operate; providers are encouraged to consider the use of such covenants in their employment agreements and to periodically have those covenants reviewed and updated by competent counsel.

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