Protect Your Business - The Three Component Test for Restrictive Covenants in Employment Contracts

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Businesses often include restrictive covenants in employment contracts for the protection of business interests. Business interests can include the protection of client lists, trade secrets, confidential information, good will and market share. Employers generally achieve these goals by restricting an employee's conduct after employment by imposing non-competition clauses, non-solicitation clauses, and confidentiality provisions in their employment contracts. These provisions are called "restrictive covenants." Employers (and employees) need to be informed about the validity of restrictive covenants and recent trends in the courts regarding standards for restrictive covenants in order to be able to protect their respective interests.

Reliable Fire Equipment Company v. Arredondo

In December 2011, the Illinois Supreme Court clarified a long standing confusion regarding the standard for determining the validity of restrictive covenants in employment contracts in a case called *Reliable Fire Equipment Company v. Arredondo*. Reliable was in the business of selling and installing fire suppression equipment. Arnold Arredondo and Rene Garcia were employees for Reliable. While working at Reliable, Arredondo and Garcia created a new business which would be in direct competition with Reliable. However, Arredondo and Garcia both signed restrictive noncompetition agreements while employees at Reliable in which they agreed not to: (1) compete with Reliable during or one year after their employment in Illinois, Indiana, and Wisconsin; or (2) solicit sales or referrals from Reliable's customers. Arredondo resigned and Garcia was fired as a result of starting the new company. Reliable then sued Arredondo, Garcia, and the new company alleging a breach of their noncompetition restrictive covenant.

Because of a multitude of conflicting appellate court decisions attempting to tackle the job of whether to enforce a wide variety of restrictive covenants, the Illinois Supreme Court finally decided to clarify and set standards for restrictive covenants in employment contracts for the State of Illinois.

The Court re-established a three component test of reasonableness to determine the validity of restrictive covenants. A restrictive covenant will be upheld in Illinois if the restraint:

- is no greater than is required for the protection of a legitimate business interest of the employer;
- does not impose undue hardship on the employee; and
- is not injurious to the public.

The Court further went on to define a legitimate "business interest." Whether a legitimate business interest exists is based on the totality of the facts and circumstances of the individual case, including such factors as: near-permanence of customer relationships, the employee's acquisition of confidential information through employment, and time and place restrictions. However, these factors is not to be exclusive and are not to be weighed differently; rather, the importance of these factors are to depend on the specific facts and circumstances of each individual case.

In *Reliable Fire*, the lower courts previously held the restrictive covenant unenforceable claiming that Reliance did not have a legitimate business interest that justified the enforcement of the non-compete agreements. The Supreme Court reversed the decisions of the lower courts after re-defining the term "legitimate business interest" and sent the case back down to the lower courts to comply with the this new definition.

Recent Application of the Clarified Restrictive Covenant Standards

Many cases have applied the new *Reliable Fire* standard for restrictive covenants using the three component test. However, because the standard is fluent, and based on the totality of the facts and circumstances of each individual case, it is hard for employers or employees to predict the validity of restrictive covenants in employment contracts.

For example, in 2012, the Fourth District Illinois Appellate Court in *Zabaneh Franchises, LLC v. Walke*r, found a non-compete agreement in a tax firm's employment agreement enforceable. The employment agreement included a provision that restricted the employee from engaging, after termination of employment, in the business of tax preparation for any company client for two years and from soliciting or hiring company employees for one year in any competitive business. The court found that the tax firm had a legitimate business interest in imposing the restrictive covenants because of its customer relationships and its investment in developing the employee's skills. It further determined the employee's interests were protected in the restrictive covenant because the employee was only limited by not being able to prepare taxes for the clients that she serviced while an employee for the tax firm; thus her right to earn a living was not diminished. Therefore, the court upheld the restrictive covenant as reasonable.

An example of when a legitimate business interest has not been found enforceable is illustrated in the 2013 decision by the First District Illinois Appellate Court in *Gastroenterology Consultants of North Shore, S.C. v. Meiselman.* In that case, the court found that a employer did not have a legitimate business interest in imposing a restrictive non-compete provision in the physician's employment contract. The employer required that all doctors associated with the company sign a non-compete agreement which prohibited a doctor separated from the practice from soliciting or treating patients directly or in connection with any entity engaged in a competitive business located within 15 miles of each of the company's offices for a period of 36 months.

The court looked at the totality of the circumstances in making its determination, and found that *Gastroenterology Consultants of North Shore ("GCNS")* did not have a legitimate business interest in restricting the physician. The physician had his own patients and own referrals from physicians before working for the company, whom he still saw while working for GCNS. The physician also had his own independent relationship with his patients; billed his patients directly; and his compensation was based on his independent practice, not GCNS's practice. The employer in this case only provided administrative support. The court held that GCNS did not have a legitimate business interest in need of protection by restricting the physician's practice after he left the company.

Also, in another 2012 decision, the Second District Illinois Appellate Court held that an otherwise "typical" non-competition and non-solicitation covenant in a salesman's contract was unenforceable, utilizing the *Reliable Fire* decision. In *Kairies v. All Line, Inc.*, the defendant employer was in the business of selling braided cords and rope, and employed Joseph Kairies as a salesman. Mr. Kairies signed a non-solicitation and non-competition agreement which restricted him from directly or indirectly soliciting any customer of All Line for two years after his termination. The agreement also restricted him from participating in the ownership, management, operation, or control of any business similar to the type of business conducted by All Line for two years. The court determined the restrictive covenants in the All Line, Inc.'s contract to be invalid and unenforceable.

The court determined that All Line did have a legitimate interest in protecting its company; however, the Court found the scope of the restrictive covenants too broad. First, the court held that the non-solicitation clause was too broad because it restricted Mr. Kairies from servicing any customer of All Line. A restrictive covenant on solicitation can restrict an employee from soliciting customers that the employee personally serviced, but generally an absolute bar on soliciting any customer is held unenforceable. All Line, Inc. could not restrict Mr. Kairies from servicing any and all customers of theirs.

Second, the court found the non-competition clause was too broad because it restricted Mr. Kairies from engaging in any activity for All Line's competitors. A non-competition covenant cannot restrict an employee from engaging in any employment position with a competitor, only employment that would harm the ex-employer. For example, a company cannot restrict an engineer from taking a janitorial job at a competitive firm. Thus, the court held that both restrictive covenants were too broad and overreaching to protect All Line's legitimate business interest, and thus, the Court held that the covenants were unenforceable.

For every case that exists where restrictive covenants are found enforceable, there is an equal number of cases where the covenant is not enforceable. There are numerous situations and issues that bear on a judge's decision, such as the reasonableness of the geographical scope of covenants, and how the courts define near-permanent relationships in determining the reasonableness of a restrictive covenant. Implementing restrictive covenants in employment contracts is essential to most businesses' survival; however, the uncertainty of the law makes it essential for the language in the restrictive covenants to be precise in order to meet the goal of a restrictive covenant, that is, to protect the business.

While the *Reliable Fire* decision was written to help guide business owners and their employees determine which restrictive covenants are enforceable and which are not, in reality, the waters are as muddy as they were before. Before drafting and implementing a restrictive covenant in an employment contract or signing an employment contract as an employee, we advise that you consult with an attorney.