INSIGHT – The Magazine of the Illinois CPA Society – Spring 2012

Think Before You Ink

How enforceable are non–compete covenants?

Management

By Brian J. Hunt, CPA/JD

Non-compete (or, more specifically, noncompetition restrictive) covenants are designed to prevent employees from working in a particular industry or geographic area for a specified period of time—hence the notion of non-compete. But signing without considering the consequences has its consequences.

How do non-compete covenants work? In the 2011 case of *Reliable Fire Equipment Co. v. Arredondo*, the Illinois Supreme Court articulated a three-pronged test to determine whether a non-compete covenant is enforceable; namely, it must not (1). exceed what is required for the protection of a legitimate employer interest; (2). impose undue hardship on the (former) employee with respect to activity, geographical area and time; and (3). be injurious to the public.

According to the Court, the employer has to establish that it has a legitimate business interest worthy of protection. Rather than being based on any rigid, inflexible formula, however, this determination is based on the "totality of the circumstances."

The Court further explained that restraint is usually justified if striving to prevent an employee from appropriating confidential and proprietary trade secrets and business information or usurping relationships with customers that are near permanent, and with whom they wouldn't have had contact if it weren't for their employment.

However, no factor is finite. All the circumstances have to be considered. Taking a closer look at *Reliable Fire Equipment Co. v. Arredondo*, Reliable sells, installs and services fire alarm and fire suppression systems for non-residential buildings, including industrial, commercial and retail businesses, hospitals and schools. Reliable's 100 employees include salespeople, installers and service technicians, and it does the majority of its business in the Chicago Metropolitan area, Northern Indiana and Southern Wisconsin. Reliable has been in business for more than 60 years.

In 1992 Reliable hired Garcia as a technician. Approximately one year later he became a salesman. In 1997 all employees—including Garcia—were required to sign non-compete covenants. In 1998 Reliable hired Arredondo as a salesperson, and he too was required to sign a non-compete covenant. Garcia and Arredondo agreed not to compete with Reliable during their employment and for one year after termination anywhere in Illinois, Indiana or Wisconsin. Garcia and Arredondo further promised not to solicit any sales or referrals from Reliable customers or referral sources, or to solicit Reliable employees to leave the company's employment.

By April 2004, however, Garcia and Arredondo had formed their own concern—High Rise, a company supplying engineering fire alarm and related auxiliary systems throughout the Chicago Metropolitan area. In August 2004 Reliable's founder and chairman became concerned that Garcia and Arredondo were planning to compete with Reliable. Both Arredondo and Garcia denied they had any such intention. On September 1, 2004 Arredondo resigned from Reliable and, shortly thereafter, Garcia was fired on "suspicion" of competition.

In December 2004 Reliable filed suit to enforce its non-compete covenants. The trial court, however, refused to enforce the covenants, concluding that Reliable failed to prove the existence of a legitimate business interest. In 2011 the Illinois Supreme Court returned the case to the trial court to determine whether Reliable had a legitimate protectable business interest based on the totality of the circumstances.

Certainly, Reliable should present evidence that Arredondo and Garcia acquired trade secrets or proprietary business information during their employment—secrets and information to which they otherwise wouldn't have had access. Reliable also should establish that the information was not made available to all employees, and that specific efforts were made to invest in, develop and protect the information through written agreements and restricted physical access. What's more, Reliable should present evidence of its investment in client acquisition and maintenance, as well as showing that its customer relationships are near permanent.

By the same token, you have to wonder whether keeping Arredondo and Garcia from working in the industry anywhere in Illinois, Indiana or Wisconsin—beyond Reliable's sales territory—is a case of overstepping, and whether keeping Arredondo out of work in that industry for one year is reasonable. Furthermore, you'd assume that the totality of the circumstances would bear differently against Arredondo, who voluntarily resigned, versus Garcia, who was fired on suspicion of competition after 12 years in the industry. You also have to wonder whether Arredondo and Garcia will be prevented from selling to Reliable customers with whom they had no personal contact during their employment.

On the flip side, the Court isn't likely to look favorably on an unrestrained effort to husband an employer's resources for personal gain—scheduling a High Rise sales call while employed at Reliable, for example. For their part, Arredondo and Garcia would be wise to establish that the industry is marked by an already high degree of competition, low investment in client acquisition and high degree of client turnover, and that Reliable had no confidential information to protect. For example, a target client list of names selected from a phone book will not, in itself, be deemed confidential or proprietary.

The door is open for ingenious employers and employees to frame their circumstances to best suit their interests. Which is why both employers and employees should think before they ink a non-compete agreement.

ICPAS member [Brian J. Hunt] is the managing principal of The Hunt Law Group, LLC (THLG), where his practice focuses on business litigation and the representation of CPAs. In 2012, THLG was selected as a "Go-To Litigation Firm for the Fortune 500."