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Contents:

Virginia Supreme Court Narrows Scope of Covenants Not to Compete

The Virginia Supreme Court recently narrowed the acceptable scope of activities prohibited by covenants not to compete in *Motion Control Systems, Inc. v. East.* In a fact-specific ruling, the court held that the prohibitory language in an employer's non-compete covenant swept too broadly, covering activities unrelated to the business of the appellant-employer. The court therefore struck down the covenant as overbroad and unenforceable.[1]

Appellant Motion Control Systems, Inc. (MCS) designs and manufactures "high performance drive systems, including brushless motors [and] amplifiers and electronic controls for the motors." Gregory East was employed by MCS from 1991 to 1998. His final position with MCS was quality and reliability engineering manager, a position that was integral to MCS management. In this position, Mr. East was involved in new product development and had access to customer lists and customer specifications.

In 1997, MCS asked employees to sign covenants not to compete. The covenant signed by Mr. East read, in relevant part:

> Employee will not[,] … directly or indirectly, own, manage, operate, control, be employed by, participate in or be associated in any manner with the ownership, management, operation or control of any business similar to the type of business conducted by the company at the time of the termination of this Agreement. The term "business similar to the type of business conducted by the company" currently includes any business that designs, manufactur[es], sells or distributes motors, motor drives or motor controls.

After resigning from MCS, Mr. East retained a position with Litton Systems, Inc. (Litton) as a

supervisor in its slip ring manufacturing operation in Blacksburg, Virginia. Litton also makes brushless motors at this plant. Based on these facts, the trial court acknowledged that Litton and MCS made some of the same products and that MCS "reasonably could be concerned" that Litton could put it out of business. Nevertheless, the trial court ruled that the covenant was unenforceable because it "imposed restraints that exceeded those necessary to protect the legitimate business interests of MCS."

To determine whether a covenant not to compete is enforceable, Virginia courts apply a three-prong reasonableness test. To be a valid covenant, (1) the restraint must be no greater than necessary to protect the employer's business interests, (2) it must not be unduly oppressive in limiting the ability of the employee to earn a livelihood, and (3) it must be reasonable as sound public policy. Because covenants not to compete are restraints of trade, they are construed strictly and, if they are ambiguous, in favor of the employee. The covenant at issue in Motion Control failed to satisfy the first prong of the reasonableness test.

MCS argued that its covenant was narrowly tailored to protect its legitimate business interest. Although the court acknowledged that prohibiting a former employee from working in "any business similar to the type of business conducted by" the employer, or from working for a competitor who "renders the same or similar services as the [e]mployer," had been upheld in the past, the covenant at issue here prohibited a broader range of activities. The MCS covenant, in attempting to specify what constituted a similar business, in fact expanded the scope of the term. The resulting definition, said the court, "could include a wide range of enterprises unrelated to the business of MCS." The court therefore upheld the trial court's ruling that the covenant was unenforceable.[2]

Moreover, the *Motion Control* court did not modify the covenant to make its restraints reasonable. Courts applying Virginia law have not adopted the "blue pencil" rule to conform overbroad covenants to the legal requirements of reasonability. A court may, however, enforce a savings clause or provision if one exists in the covenant. Upon severing unreasonable clauses from a covenant, the court may modify the previously unenforceable covenant according to its savings clause. However, drafters of covenants not to compete should be aware that, although some courts may enforce savings clauses, others have refused to do so.

Motion Control cautions drafters of non-compete covenants in Virginia to take care when delineating the scope of restricted activities. Any attempt to describe the employer's type of business must be precise and limited to those businesses representing a threat to the employer's legitimate business interests. Failure to do so could render the entire clause unenforceable, as Virginia courts are not likely to blue pencil faulty provisions. Employers should also continue to be aware that the validity of non-compete covenants, even if limited in accordance with the guidelines of *Motion Control*, cannot be guaranteed. The reasonableness test leaves room for judicial discretion, and because non-compete covenants restrain trade, ambiguities are likely to be resolved in favor of employees.

California Court of Appeal Finds Employee's Termination for Refusal to Sign Unlawful Covenant Violates Public Policy

On November 21, 2001, the California Court of Appeal sent a warning to employers attempting to circumvent California's longstanding policy favoring employee mobility over employers' competitive interests by affirming a damage award of over $1.25 million against Aetna U.S. Healthcare (Aetna). In *Walia v. Aetna*, Inc., the court affirmed the San Francisco Superior Court's ruling that (1) the non-compete covenant that Aetna required California employees to sign violated California law and (2) the termination of an employee principally for her refusal to sign the unlawful non-compete covenant violated public policy.

After the 1996 merger of Aetna and U.S. Healthcare, Aetna presented employees with its Non-Compete and Confidentiality Agreement (the Agreement). The Agreement contained a non-compete covenant preventing employees who signed from working, for six months after departing Aetna, for a competitor in the same state in which they had been employed by Aetna or within a fifty-mile radius of the sales territory served by the employee while at Aetna. [3] In early 1997, Aetna informed Anita Walia, an account manager in the San Francisco sales organization, that she was required to sign the Agreement. Aetna informed her that, if she did not sign and could not find a comparable position at Aetna that did not require her to execute the Agreement, she would be terminated. Ms. Walia determined that the Agreement was unenforceable in California, and therefore she refused to sign or to accept an alternative position as an underwriter. She was subsequently fired on June 27, 1997 for "failure to meet the requirements of [her] position," despite prior reviews for "very good" job performance. Ms. Walia sued Aetna, claiming that her termination violated public policy.

California Business and Professions Code Section 16600 (Section 16600) provides that "every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void." Enacted in 1872, Section 16600 represents California's public policy that "the interests of the employee in his own mobility and betterment are deemed paramount to the competitive business interests of the employers."

The trial court ruled that the Agreement violated Section 16600 and instructed the jury that Aetna was liable for wrongful termination if the principal reason for Ms. Walia's termination was her refusal to sign the Agreement. The jury found that Aetna had terminated Ms. Walia for her failure to sign the Agreement and awarded her over $1.25 million in damages.[4]

Aetna appealed the trial court's decision, arguing that the non-compete covenant did not violate Section 16600 because it only narrowly restrained competition, was necessary to protect Aetna's trade secrets and was severable from the rest of the Agreement. Aetna further contended that, even if the Agreement violated Section 16600, Ms. Walia's termination for failing to sign the Agreement did not violate public policy.

The court found that the Agreement did not fall within the "narrow restraint" exception to Section 16600. This limited exception, generally applicable only in connection with a business transaction, is rarely applied by California courts. The Agreement's prohibition against Ms. Walia accepting a sales position for any health care company or health insurance provider in California, even though the restriction was limited to only six months, was not narrowly tailored and did not fall into the "narrow restraint" exception.[5]

The court also found that the non-competition provisions of the Agreement were not necessary to protect Aetna's trade secrets, another narrow exception to Section 16600. The court recognized that a company generally may legitimately seek to prevent disclosure of its confidential information or trade secrets by entering into non-disclosure and non-solicitation agreements. However, the court disagreed with Aetna's argument that preventing Ms. Walia from working in the health care industry was necessary to protect Aetna's trade secrets. Rather, the court found that such a broad restriction, preventing the employee from working in her chosen field, was overly broad and unenforceable.

Aetna argued that the non-compete covenant did not violate Section 16600 because the objectionable covenant could be severed from the rest of the Agreement, rendering the non-disclosure and non-solicitation covenants enforceable. The court rejected Aetna's argument, stating that the result would be to allow "an employer [to] fire an employee for refusing to sign an agreement containing provisions in direct violation of public policy, then escape liability on the grounds that other provisions of the agreement were inoffensive." The court explained that California's policy favoring competition would be undermined if employers could use broad, illegal non-compete covenants in employment agreements because significant numbers of employees would honor the agreements without challenge or advice of counsel.

Finally, the court found that Ms. Walia's termination for refusal to sign the illegal non-competition agreement violated California's public policy and formed the basis for a wrongful termination claim. In California, an employee may bring a wrongful termination claim when an employer discharges the employee "for refusing to do something public policy condemns." [6] Because California's public policy disfavors non-compete covenants, and because Ms. Walia was fired for refusing to sign one, the court affirmed the trial court's jury instruction and ruling that Aetna was liable for wrongful termination.

Walia instructs employers of California employees to tread lightly when considering non-compete covenants. Given California's limited exceptions to its policy against non-compete covenants, employers may be tempted to present narrowly drawn non-compete covenants to employees. California courts, however, apply exceptions to the rule of Section 16600 only rarely, and California employers may therefore find themselves unable to enforce even legal non-disclosure and non-solicitation clauses contained in illegal non-competition agreements. Thus, employers should seek legal advice before attempting to enter into non-competition agreements in California, as even narrowly drawn non-compete covenants will be subject to great scrutiny by California courts implementing the policy of Section 16600.

Maryland Becomes Twelfth State to Prohibit Discrimination Based on Sexual Orientation

On November 21, 2001, Maryland became the twelfth state to prohibit discrimination based on sexual orientation[7] with the passage of the Maryland Antidiscrimination Act of 2001 (the Act). The Act prohibits discrimination based on sexual orientation in housing, employment, and places of public accommodation, and makes existing remedies for discrimination applicable to discrimination on the basis of sexual orientation.

Maryland Governor Parris N. Glendening signed the Act on May 15, 2001. It was to have taken effect

on October 1, 2001, but Take Back Maryland, an organization opposed to the law, spearheaded an effort to collect more than 47,500 certified signatures on petitions to force the law onto the November 2002 ballot as a referendum.[8] In response, Free State Justice, Maryland's gay, lesbian, bisexual and transgender lobby, and the Gay, Lesbian, Bisexual and Transgender Community Center of Baltimore and Central Maryland (GLCCB), filed suit in the Circuit Court for Anne Arundel County on July 30, 2001 against the Maryland Secretary of State and the Maryland State Board of Elections to challenge the validity of 7,292 signatures. Take Back Maryland joined the suit as a co-defendant.

The lawsuit alleged that certain signatures on the petitions to refer the Act to the General Election ballot were invalid for a number of reasons, including failure to include a printed summary of the Act on the reverse side of the petition as required by statute, failure to witness signatures properly, and missing or altered dates on affidavits submitted with several petition forms.[9] In their prayer for relief, the plaintiffs sought, among other things, an order permitting the Act to take effect as planned on October 1, 2001.[10] A special master appointed to the case identified problems with approximately 7,300 signatures. The lawsuit was settled on November 21, 2001 when Take Back Maryland acknowledged that it had not collected enough valid signatures to force a referendum. The Act immediately went into effect, and its coverage extends from October 1, 2001.

The Act defines "sexual orientation" as "the identification of an individual as to male or female homosexuality, heterosexuality, or bisexuality." Under the Act, employers may not fail or refuse to hire or discharge any individual, or otherwise discriminate against any individual with respect to his or her compensation, terms, conditions, or privileges of employment, because of his or her sexual orientation. The Act exempts religious organizations from its prohibitions and applies only to employers of fifteen or more employees.

The Act explicitly excludes certain activities from its coverage. For example, it does not authorize or validate marriage between two individuals of the same sex, it does not require an employer to offer health insurance benefits to unmarried domestic partners, and it does not mandate any educational institution to promote any form of sexuality or sexual orientation or to include such matters in its curriculum. Moreover, the Act does not apply to the Boy Scouts of America or the Girl Scouts of America with respect to the employment of individuals of a particular sexual orientation.

The Maryland Commission on Human Relations (MCHR) enforces Article 49B of the Maryland Code by investigating complaints of discrimination based on race, color, sex, familial status, national origin, age, religion, marital status, physical and mental disability and genetic information. On November 30, 2001, the MCHR announced that it is accepting complaints of discrimination based on sexual orientation and that, beginning in January 2002, it will provide training upon request to introduce employers to the Act's protections and to address issues involving sexual orientation. Upon finding that an employer has committed a violation of the Act, the MCHR may issue cease and desist orders, order reinstatement with or without backpay, and grant other appropriate equitable relief.[11]

Given the Act's addition of sexual orientation to the list of categories of unlawful bases of discrimination, employers operating in Maryland and those who employ Maryland residents should

revise their employment policies to prohibit discrimination based on sexual orientation and to investigate complaints of sexual orientation discrimination as vigorously as they investigate complaints based on other forms of discrimination. Employers should also consider training opportunities for a thorough introduction to the new issues raised by the Act and for assistance addressing issues surrounding sexual orientation and the workplace. By taking these and other affirmative measures, employers can limit their exposure to claims of sexual orientation discrimination.

1 The court's inquiry focused solely on the business activity restriction. The two-year time period and one-hundred mile area covered by the covenant were not at issue in the appeal.

[2] In a separate but related holding, the court reversed that portion of the trial court's judgment enjoining Mr. East from disclosing MCS's "confidential, trade secret, or proprietary information to anyone." The trial court found that Mr. East had knowledge of MCS trade secrets, but did not find that he had disclosed or threatened to disclose such information. Because "mere knowledge of trade secrets is insufficient to support an injunction," the Supreme Court reversed that portion of the trial court's ruling.

[3] The Agreement also contained non-solicitation, non-disclosure and cooperation covenants.

[4] The jury awarded Ms. Walia $54,312 in compensatory damages, $125,000 in emotional distress damages and $1,080,000 in punitive damages.

[5] In support of its analysis, the court cited a case in which the court rejected the narrow restraint argument as to the same Aetna non-compete covenant.

[6] To succeed on such a claim, an employee must show that: (1) the public policy is supported by constitutional or statutory provisions; (2) the policy benefits the public, not just the individual; (3) the policy has been articulated at the time of the employee's discharge; and (4) the policy is substantial and fundamental.

[7] Other states with similar statutes include California, Hawaii, Wisconsin, Minnesota, Nevada, New Jersey, New Hampshire, Massachusetts, Vermont, Rhode Island and Connecticut. In addition, nine states currently protect public – but not private – employees from sexual orientation discrimination: Colorado, Delaware, Illinois, Montana, New Mexico, New York, Pennsylvania, and Washington. Prior to the Act's enactment, Howard, Montgomery and Prince George's Counties protected employees of private employers against discrimination based on sexual orientation.

[8] Maryland requires 46,128 signatures from qualified voters, calculated from the number of votes for governor cast in the last gubernatorial election, to refer an Act of the General Assembly to the 2002 General Election ballot.

[9] The lawsuit also alleged that representatives of Take Back Maryland obtained or attempted to obtain signatures to the petition by fraud or misrepresentation and that the referral of the Act to the General Election ballot violated the Maryland Constitution because no law regulating the sale of

alcohol may be referred to an election ballot or repealed through referendum.

[10] The plaintiffs also sought judgments declaring that the referral of the Act to the General Election ballot violated the Maryland Constitution and that the petition failed to satisfy the requirements for referral, as well as orders directing local boards of election to invalidate signatures that did not meet the requirements for certification and enjoining the Secretary of State from certifying the ballot question regarding repeal of the Act.

[11] The MCHR may not, however, award tort damages, such as punitive or compensatory damages.