

## **Are Noncompetition Agreements Enforceable?**

By:

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Anyone who has ever had his or her best employee leave, become a fierce competitor, and take away key customers, knows the importance of enforceable noncompetition agreements. North Carolina, as well as many other states that follows principal of common law<sup>1</sup>, will enforce a properly drafted, tailored noncompetition agreement that is reasonably limited as to time and territory. From a practical standpoint, most noncompetition agreements are probably not enforceable or not completely enforceable for one or more reasons. In many instances, what began as a legally enforceable noncompetition agreement intended for a specific use became a form that was misused over time. In some instances, the form simply was not updated over the years as the law pertaining to noncompetition agreements evolved.

**Elements** – Under applicable law in North Carolina, a noncompetition agreement is enforceable in equity if it is:

- 1) In writing,
- 2) Entered into at the time and as part of the contract of employment,
- 3) Based on a valuable consideration,
- 4) Reasonable both as to time and territory embraced in the restrictions,
- 5) Fair to the parties, and
- 6) Not against public policy.

See *Forrest Paschal Mac. Co. v. Milholen*, 27 N.C. App. 678, 220 S.E.2d 190 (1975); *Brooks Distrib. Co. v. Pugh*, 91 N.C. App. 715, 373 S.E.2d 300 (1988), rev'd on other grounds, 324 N.C. 326, 378 S.E.2d 31 (1989); *Hartman v. W. H. Odell & Associates. Inc.*, 450 S.E.2d 912 (N.C. App. 1994).

**Must be Tailored** – All too often the problem with the typical noncompetition is that it was drafted for one purpose and used for another. A noncompetition agreement intended to be used by an engineer or research scientist is often not proper for use by a salesperson or project manager. All too often companies attempt to do a “one size fits all” variety of noncompetition agreement/clause.

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<sup>1</sup> Some states have adopted statutes that allow courts to modify rather than choose between enforcing or invalidating noncompetition agreements. States, as well as State Courts and State Court Judges, vary on their willingness to enforce such agreements.

**Primary Purpose: Protect Customer Base** – The primary purpose of a noncompetition should be to protect the employer’s customer base. Its primary purpose should not be to stifle competition or to deny the employee the right to make a living in his or her chosen profession. However, because the law in North Carolina and a number of states evolved over many years, including horse and buggy days, there are requirements to be enforceable that a noncompetition contract contain “time and territory” restrictions. This is true even though an employer’s customer base may be spread all over the United States. Noncompetition law in North Carolina does not adequately address the fact that “time and territory restrictions” do not provide adequate protection to employers when valued customers are nationwide or worldwide. For example, if a noncompetition prohibits an employee from competing anywhere in the state of North Carolina, the employee can sometimes simply move to another state, set up a competing business, and take all or most of the customers of his former employer. If instead, the employer uses only a customer restriction, that would violate the requirement to have a “reasonable time-and-territory” restriction. As noted below, some courts have enforced a "customer only" restriction with no stated territory.

**“Time and Territory”** – Under North Carolina law, to prove that a geographic restriction in a covenant not to compete is reasonable, an employer must first show where its customers are located and that the geographic scope of the covenant is necessary to maintain those customer relationships. *Hartman v. W. H. O’Dell and Associates, Inc.*, 450 S.E.2d 912 (N.C. App. 1994). “A restriction as to territory is reasonable only to the extent it protects interest of the employer in maintaining [its] customers.” (Emphasis added.) *Hartman, supra*, quoting from the language in *Manpower of Guilford County, Inc. v. The Hedgecock* 42 N.C. App. 515, 523, 257 S.E.2d 109, 115 (1979). (Emphasis added.) *See also Carolina Pride Carwash, Inc. v. Kendrick*, 618 S.E.2d 875 (N.C.App. 2005). As a general rule, when a covenant not to compete is overly broad, North Carolina courts will not save it by “blue penciling” the agreement to make it “reasonable.” *Hartman, supra*. There are some very limited exceptions. From the foregoing, it is important that an employer not simply adopt a “50-mile” or “200-mile” restriction, but make a concerted effort to determine where the employer’s customers are actually located. Regarding “time,” courts often uphold one year and often look hard at more than two years. However, a small territory can be paired with a longer time, and a short time period can be paired with a larger territory.

North Carolina courts also appear to have recognized customer-based restrictions as a substitute for territorial or geographic restriction. *See Wade S. Dunbar Insurance Agency, Inc. v. Barber*, 147 N.C.App. 463 (N.C.App. 2001), 556 S.E.2d 331 (No. COA01-345) and cases cited therein as well as *Market America, Inc. v. Christman-Orth*, 135 N.C. App. 143,

520 S.E.2d 570 (1999) and cases cited therein. The courts have enforced noncompetition agreements that did not contain a geographic territory restriction but contained restrictions on soliciting existing customers of the employer.

**Noncompetition Agreements: Not Favored; Must Be Reasonable** – Noncompetition agreements are generally enforceable only in a) employer-employee relationships, and b) buyer-seller relationships where a business is sold. The annotations to N.C.G.S. Chapter 75 Monopolies, Trusts, etc., and specifically N.C.G.S. §75-1, “Combinations in restraint of trade illegal” recite that agreements not to compete are not favored in law. Quoting from cases construing the statutes: “An individual’s voluntary contractual restraint on his right to carry on his trade or calling is prima facie illegal and must be shown to be reasonable by the parties seeking to enforce it.” (Citations omitted.) In *Hartman v. W. H. Odell & Associates, Inc.*, 450 S.E.2d 912 (N.C. App. 1994), the Court stated:

"Accordingly, to prove that a geographic restriction in a covenant not to compete is reasonable, an employer must first show where its customers are located and that the geographic scope of the covenant is necessary to maintain these customer relationships."

"A restriction as to territory is reasonable only to the extent it protects the legitimate interests of the employer in maintaining [its] customers. *Hartman*, Page 917. "The employer must show that the territory embraced by the covenant is no greater than necessary to secure the protection of its business or goodwill... if the territory is too broad, "the entire covenant fails since equity will neither enforce nor reform an overreaching and unreasonable covenant."

In the case of *Manpower of Guilford County, Inc. v. Hedgecock*, 42 N.C. App. 515, 257 S.E.2d 109 (1979) the Court stated: "Where the alleged primary concern is the employee's knowledge of the customers, if the territory should only be limited to areas in which the employee made contacts during the period of his employment."

**Overly-Broad Restrictions** – Employers should take care to avoid using unnecessarily broad language in restricting what an employee may do upon termination of the employee. Courts may refuse to enforce prohibitions such as a requirement that an employee refrain from "engaging in any conduct or business *in competition with*" the employer's business rather than simply stating the employee will not engage in the employer's business. Although the maker of a soft drink may have a legitimate interest in precluding a

former key employee from working for a soft drink company, that is not justification for prohibiting the employee from working for all the companies that make products that satisfy the need of thirsty customers—water, orange juice, milk, and so forth. In like fashion, an employer should avoid broad restrictive language such as a prohibition against going to work for “any company that designs, manufactures, or distributes” in a situation where such a restriction is simply not necessary. For example, if that language were used in an effort to preclude a toolmaker from designing or manufacturing tools for another toolmaking company, there would be no good reason to deny the toolmaker the right to work as a sales clerk for Sears or Wal-Mart simply because those companies also “sell and distribute tools” as well as many other products.

In *Electrical South, Inc. v. Lewis*, 96 N.C.App. 160, 385 S.E.2d 352, (N.C.App. 1989), the Court refused to enforce a territorial restriction that reached beyond the employer and also added that “the employee will not, directly or indirectly own... or be connected in any manner with... any concern... which competes directly or indirectly with the company” within the territory. The net effect would have prohibited the employee (or his family) from working for a company anywhere in the world if that new employer also worked “in the territory.” Thus even if the employee move thousands of miles from the former employer, he could not work for a large company that competed in his former territory. The Court of Appeals criticized the “shotgun” approach to drafting noncompetition provisions and refused to enforce it at all.

**“Covenant of Good Faith and Fair Dealing”—Jury Trial**—“In every contract there is an implied covenant of good faith and fair dealing that neither party will do anything which injures the right of the other to receive the benefits of the agreement, and each party is deemed to have agreed to act in good faith in performing the contract.” *Bicycle Transit Authority, Inc. v. Bell*, 314 N.C. 219, 228, 333 S.E.2d 299, 305 (1985), North Carolina Pattern Jury Instructions Civil 501.01. Contracts - Issue of Formation. If coupled with questionable conduct on the part of an employer, this covenant could be fertile ground for an employee to raise jury issues about the fundamental fairness of actions and inactions of an employer who makes promises to an employee to induce the employee to sign a noncompetition agreement and then unreasonably denies the employee the right to pursue his or her chosen field of employment.

**Independent Contractors** – Many companies seek to impose noncompetition requirements on “1099 employees” or, more accurately, independent contractors. It is abundantly clear that the language quoted above under **Elements**, “at the time as part of the contract of employment” envisions that there is in fact an employer-employee relationship.

Even more importantly, the entire concept of “independent contractor” envisions “independence.” For example, a distributor who sells a number of lines acts independently of any one manufacturer. Furthermore, an agreement by a distributor to sell only one manufacturer’s product is often the very “restraint of trade” that Chapter 75 and anti-trust laws generally are designed to prohibit. The North Carolina Court of Appeals has allowed a six-month noncompetition agreement to be enforced. See *Market America, Inc. v. Christman-Orth*, 135 N.C. App. 143, 520 S.E.2d 570 (1999). However, the Court of Appeals in *Market America, Inc.* relied on an earlier decision, *Starkings Court Reporting Services, Inc. v. Collins*, 67 N.C. App. 540, 313 S.E.2d 614 (1984), which actually refused to enforce the particular noncompetition agreement as being an unreasonable restraint on competition.

**Proprietary Information** – Employers can also use clauses to protect customer lists, pricing strategies, trade secrets, and much more. This includes marketing and sales information as well as technical information. As courts will often protect proprietary data when they will not enforce a noncompetition clause, employers should always have a “Proprietary Information” clause in the employee’s contract when it is appropriate to do so.

**Risks to and Rights of New Employers** – Under established North Carolina case law, interference with contract is justified if it is motivated by legitimate business purpose, as when plaintiff and defendant are competitors. See *Embree Const. Group v. Rafcor, Inc.*, 30 NC 487 (411 S.E. 2nd 911 (1992) See also *People’s SEC Life Ins. Co. v. Hooks*, 322 NC 216, 367 S.E. 2nd 647 (1988), in which the Court recognized that a competitor is privileged to hire away employees even in the face of noncompetition agreements. (See, to the contrary, *United Laboratories, Inc. vs. Kuykendall*, 322 N.C. 643, 665, 370 S.E.2d 375, 389 (1988)). Quoting the Court in *Hooks*:

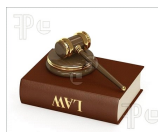
"The motion under Rule 12(b)(6) should be granted when the complaint reveals that the interference was justified or privileged... Numerous authorities have recognized that competition in business constitutes justifiable interference in another's business relations and is not actionable so long as it is carried on in furtherance of one's own interest and by means that are lawful."

**Risks to Employer: Enforcing an Invalid Agreement** – An employee improperly denied a new job because of his or her prior employer’s attempt to enforce an invalid noncompetition contract can sometimes sue the former employer for “tortious, intentional interference with contract,” being the contract with the new employer. See *American Marble Corporation v. Crawford*, 84 N. C. App. 86, 351 S.E.2d. 848 (C.A 1987). That decision is

consistent with the view that a competitor is privileged to hire away employees even in the face of noncompetition agreements. See the *Peoples Security Life Insurance Co. v. Hooks* case cited above. According to the courts, the benefits of competition outweigh any claim by the former employer to some “right” to hold onto customers forever. In *American Marble Company v. Crawford*, the Court of Appeals reversed the trial court for granting summary judgment against the employee's claim for wrongful, malicious interference with contract rights where the employee's evidence tended to establish that a valid contract existed between him and his new employer, the former employer had knowledge of the contract, the former employer intentionally induced the new employer not to perform its employment contract with the employee, the former employer's acts caused the employee actual damages, and the former employer acted without justification in that the former employer was seeking to enforce a covenant not to compete that was legally invalid as an unreasonable restraint of trade.

Stated otherwise, *American Marble Company v. Crawford* holds that an employer who interferes with an employee's new employment relationships in an attempt to enforce a covenant not to compete does so at the employer's peril. If in fact the covenant not to compete is determined to be invalid, the employer may be liable to the employee for wrongful or malicious interference with contract rights for its actions in attempting to enforce a covenant not to compete that by law constitutes an “unreasonable restraint of trade.”

**Evolving Law; Choice of Law** – The law pertaining to noncompetition agreements is not static but continues to change and evolve. In addition, a number of states have enacted statutory noncompetition laws with "savings clauses" to avoid the all-or-nothing approach of many courts. Equally important is the issue of choice of law, choice of forum and conflicts of law and whether a state court will enforce a “home state” choice of law. An excellent analysis appears in the November 3, 2011 Order entered in a North Carolina Superior Court case, *Azko Nobel Coatings, Inc. v. Rogers*, 2011 NCBC 41 (The Order can be viewed online at [www.ncbusinesscourt.net/opinions/2011\\_NCBC\\_41.pdf](http://www.ncbusinesscourt.net/opinions/2011_NCBC_41.pdf)). It is a good idea to have an expert in the field review company noncompetition forms, clauses, and procedures every few years, even if an experienced attorney approved the initial form used by the employer.



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