To restrain or not to restrain. . .

What's the best way to keep your staff from changing sides?

By DAN BLOCK

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The president of a corporate client asks you to review a contract for a joint venture with another business, in which the other company's employees will be performing work in your client's plant. The other company provided the draft agreement, but the deal looks very good to your client. In the course of your review, you find some provisions of concern, and will try to get them changed.

Then, you discover a section in which each company agrees not to hire employees of the other company during the term of the contract, and for six months thereafter. You may have seen this type of provision before, and you may believe that it is fair to each party — and a reasonable restriction given the circumstances of the arrangement contemplated by the contract.

In spite of the fairness and reasonableness to both parties, should you object to this provision and encourage your client not to agree to its inclusion in the contact? Based on the decisions of courts in several jurisdictions, the answer to this inquiry may be "yes," or at least you should advise your client to beware.

The problem with these "no-switching" agreements is that they bind a person (that is, an employee) who is not a party to the agreement, and who may not know of, or approve of, the agreement. In addition, these agreements may restrict employees from seeking job opportunities with companies other than competitors of the existing employer.

A typical reaction of lawyers questioned about the advisability of no-switching agreements is their position that
the risk is minimal. One reason is their belief that the restraint is too insignificant to cause a problem. The reality is that courts have invalidated agreements restricting an employee from employment at only one other company. Another reason why the risk is perceived to be low is the belief that an individual employee does not have the resources to effectively challenge the restraint. However, cases have been brought by individual employees; by employees and their prospective employers; by companies challenging a breach of the agreement by the other party to the agreement; and by companies trying to enforce the agreement.

Claims have been brought under federal antitrust law, or state law, or both. Although the results are mixed, some have succeeded in getting past summary judgment to decisions in their favor, or to favorable settlements.

Challengers of no-switching agreements have found varying degrees of success with their claims under federal antitrust law in four of the federal circuit courts of appeal. Final judgments on the merits as well as more recent activity has occurred in decisions based on state laws. A case decided in 1998 is interesting both for its holding, and because of the manner in which it originated.

Rickey Lamar Densmore was manager of the programming services department for Communications Technical Systems Inc. (CTS). In 1994, CTS entered into an agreement with Gateway 2000 Inc., in which CTS would provide programming services to Gateway. CTS sent Densmore to work with Gateway’s accountants in Chicago, and then in Gateway’s production facility in South Dakota.

Later that year, Gateway entered into an agreement with CTS not to solicit or hire any CTS employee without written approval of CTS. Densmore became unhappy with CTS and inquired about a job with Gateway. He then learned from Gateway’s legal department about the no-switching agreement, and was told that Gateway would not even talk to him about employment.

At the end of the year, Gateway terminated the programming-services relationship with CTS, and Densmore resigned from CTS in January of 1995. Densmore advised Gateway that he was available for employment with Gateway through his consulting business, and that he did not have a noncompetition agreement with CTS. Gateway then issued a purchase order for services by Densmore’s business.

In 1996, CTS brought suit in South Dakota circuit court against Gateway and Densmore seeking a declaratory judgment on the validity of the no-switching agreement, and for breach of contract and tortious interference with business relationships. Each of the parties made motions for summary judgment.

On appeal of the circuit court decision finding the no-switching agreement unenforceable, the South Dakota Supreme Court also found the agreement void; but on a slightly different basis than the circuit court. The Supreme Court held that the agreement was “overbroad under SDCL 53-9-11.” This section of South Dakota law states that “every contract-restraining exercise of a lawful profession, trade or business is void to that extent, except as provided by ' 53-9-9 to 53-9-11, inclusive.” The exceptions to 53-9-11 involve the sale of a business, dissolution of a partnership and employee covenants not to compete — none of which applied to the no-switching agreement. The court stated that:

CTS improperly seeks the best of both worlds. Reserving its rights under the "at-will" employment doctrine, it wants to be able to fire Densmore for any reason . . . or no reason at all. However, should Densmore seek employment or a consulting contract with a former customer, CTS wants that to be forbidden fruit even though Densmore never agreed to any such limitation.

Because the no-switching agreement was void, the breach of contract and tortious interference claims were also properly dismissed. Communication Technical Systems Inc. v. Densmore , 583 N.W.2d 125 (S.D. 1998).

Other states’ statutes contain language like that found in the South Dakota restraint-of-trade provision, 53-9-11. These other states have exceptions to the applicability of their contracts in restraint-of-trade provisions that are like those in 53-9-11. In one of those states, the Supreme Court reached the same result as in Densmore in applying the statute to a no-switching agreement.

Two companies that were in the same type of manufacturing business, Defco Inc. and Decatur Cylinder, entered into a contract in which Defco sold some assets to Decatur. One section of the contract required the agreement of both parties before either company could employ former employees of the other. A few months after the contract was signed, Decatur hired two of Defco’s employees. Defco filed suit against Decatur for, among other claims, breach of contract and intentional interference with contractual and business relations.

The Alabama Supreme Court cited 8-1-1(a) of the Alabama Code, which contains language like the South Dakota restraint-of-trade statute (along with the sale of business, employee noncompete, and dissolution of partners exceptions in subsections (b) and (c)). The court held the no-switching agreement in this case to be unenforceable under 8-1-1, just as it had done in a previous case decided by the court. The court stated that:

Without a showing that the employee had an enforceable noncompetition agreement with the plaintiff, or that the defendant did more than simply hire its competitor’s employee, we see no basis for allowing an action for intentional interference...
The breach-of-contract claim also failed because the no-switching agreement did not fit into any of the exceptions to 8-1-1(a). *Defco v. Decatur Cylinder Inc.*, 595 So.2d 1329 (Ala. 1992).

As mentioned above, the cases brought in federal court under federal law generally have not yielded definitive answers to the question of whether no-switching agreements are legal. With one exception, the appellate courts have typically just determined that the no-switching agreements may enable the plaintiffs to state a claim under the federal antitrust laws.

One case involved an airplane engineer, Robert Roman, who worked at Boeing through a contract with Butler Service Corp. He applied for a position at Cessna Aircraft Co., and he alleged that Cessna officials told him they needed workers with his experience, and he could expect an offer. He also claimed that he was later told that Cessna could not offer him a job "solely because of an agreement between Cessna and Boeing that they would not hire engineers away from each other." He filed a complaint against Boeing and Cessna under Sherman Act 1 and 4 and state law.

Sherman Act 1 says that:

Every contract, combination in the form of a trust or otherwise, or conspiracy in restraint of trade or commerce among the several states, or with foreign nations, is hereby declared to be illegal. . . .

Lawyers familiar with antitrust law know that 1 does not, according to U.S. Supreme Court decisions, mean that every contract, combination in restraint of trade or commerce is illegal. Rather, it means only that every contract, combination or conspiracy in unreasonable restraint of trade or commerce is illegal. The challenge for lawyers and the courts is determining what is "unreasonable."

The appeals court reversed the district court decision dismissing the case for failure to state a claim. The court cited other cases regarding no-switching agreements, stating that "the relevant cases hold that plaintiffs whose opportunities in the employment market have been impaired by an anticompetitive agreement directed at them as a particular segment of employees have suffered an antitrust injury under the governing standard." *Roman v. Cessna Aircraft Co.* 55 F.3d 542 (10th Cir. 1995).

According to two of the lawyers involved in the case, after the appeals court decision, Boeing was dismissed from the case, and Roman entered into a confidential settlement with Cessna.

The Seventh Circuit also held that a no-switching agreement between two companies might violate federal antitrust law. (See *Nichols v. Spencer International Press Inc.*, 371 F.2d 332 (7th Cir. 1967).)

The fact that several courts have found no-switching agreements between just two companies to be in conflict with, or possibly in conflict with, the law should raise concern for businesses considering these types of agreements. Companies that enter into joint ventures with several other companies, and include no-switching agreements in all of those contracts establishing the joint ventures, should be even more concerned. In that situation, their employees may be precluded from accepting employment with a significant portion of the employers having opportunities for someone with their particular expertise. In addition, more of their employees might be affected by the restrictions. The result is greater risk, and, potentially, the interest of government regulatory agencies.

For example, two cases involved conspiracies to restrain trade among groups of competitors. In a case brought by the Federal Trade Commission against several magazine solicitation companies, the court held that the no-switching agreement violated federal antitrust law under the Sherman Act. As a result, it affirmed a decision of the Federal Trade Commission enjoining the parties to the agreement from enforcing its provisions. *Union Circulation Company v. Federal Trade Commission*, 241 F.2d 652 (2nd Cir. 1956).

In the other case, a securities salesman filed a complaint against the National Association of Securities Dealers and some of the member companies, alleging that express or tacit agreements among the companies had been made in which a firm would not hire a salesperson who had been rejected or discharged by another firm. The appeals court reversed a district court decision dismissing the case. In favorably citing the *Nichols* court decision in the 7th Circuit, the court held that the no-switching agreement was sufficient to state a claim under the Sherman Act. The court also said that the plaintiff may be able to establish a claim for treble damages under the Clayton Act. (*Quionez v. Nat. Ass'n of Securities Dealers Inc.*, 549 F.2d 824 (5th Cir. 1976).)

As often occurs when courts in different jurisdictions apply the same statutory language to a particular type of business activity, not all jurisdictions are in agreement on this issue. There has been at least one state that provided a definitive victory for employers. Additionally, as discussed at the end of this article, one state may allow employers to be compensated when another business hires its employees (which may reduce the chances of this occurring).

The Virginia Supreme Court distinguished itself in a case brought under Virginia law. This decision is notable because Virginia has a contracts in-restraint-of-trade provision similar to the South Dakota and Alabama statutes. *Therapy Services Inc. v. Crystal City Nursing Center Inc. et al.*, 389 S.E.2d 710 (Va. 1990) involved a no-switching agreement between a nursing facility and a provider of rehabilitation therapy programs. Crystal City
Nursing Center agreed not to hire any of Therapy Services staff for the duration of their services contract and for six months thereafter. After the contract was terminated by Crystal City, Crystal City began efforts to hire employees of Therapy Services. Therapy Services then brought suit for an injunction to prevent Crystal City from hiring its employees as well as for breach-of-contract damages. The lower court found the no-switching agreement to be against public policy, but the Supreme Court reversed that decision. The court cited a 1905 Virginia case for the rule that:

Whether or not the restraint is reasonable is to be determined by considering whether it is such only as to afford a fair protection to the interests of the party in favor of whom it is given, and not so large as to interfere with the interest of the public.

The court then determined that the restriction was reasonable, because it only restrained the employees from working at one facility, and only for six months after the contract’s termination.

The law concerning no-switching agreements is unclear in many jurisdictions, and is in a "developing" status at this time. However, because of this developing status, and the court decisions invalidating or questioning the legality of these agreements, lawyers advising businesses should recognize the risk.

No-switching agreements set a potential trap for an employer. What should the employer subject to a no-switching agreement do when an employee of the other company approaches it for a job — enforce the agreement and face possible antitrust liability or breach the agreement and face possible damages under the agreement? What about the other situation when the other company refuses to hire that company’s employee because of a no-switching agreement?

It appears that the safest way to achieve at least some of the results desired from no-switching agreements is for each company to control its own employees through employee noncompetition agreements that comply with state law. Then, companies should refuse to enter into no-switching agreements altogether or at least those that exceed the constraints of each company’s employee noncompetition agreements. For employee noncompetition agreements to be enforceable, it is likely that the law in a particular state requires that the employee enter into the noncompetition agreement only at the time of employment or on a change in status, such as a raise or promotion — and the restriction must be reasonable under the circumstances.

If both businesses have employee noncompetition agreements, a no-switching agreement may not be needed. In addition, the existence of an employee noncompetition agreement makes a no-switching agreement much more likely to be enforceable.

Unfortunately, this alternative course of action will not work in a state that does not permit employee noncompetition agreements. Thus, for example, businesses in California cannot achieve the desired result through employee noncompetition agreements. But, if the businesses cannot restrict their employees directly, can they do so legally by the indirect means of no-switching agreements? The answer, in California, appears to be, "not exactly." While not precluding another business from hiring its employees, a business may — in limited circumstances — be able to require the other business to pay a fee when hiring its employees. The fee can only be reasonable compensation to the original employer for its efforts; such as in recruiting, training or supplying employees to the other business. See *Webb v. West Side Dist. Hosp.*, 193 Cal.Rptr. 80 (Cal.App.2 Dist. 1983).