



Covenants

Not to Compete

AN OLD  
DOG WITH  
A NEW BITE



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AND  
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Employers have long used covenant not to compete provisions in employment contracts to protect themselves from unfair competition that can occur when an employee leaves, often taking specialized knowledge and trade secrets along to a new employer. Courts have strictly scrutinized such provisions, however, to ensure employers are not unfairly preventing former employees from obtaining gainful employment in their chosen profession.

**I**n recent years, Arizona courts have been particularly wary of such covenants and have issued a series of decisions critical of overbroad covenants contained in employment contracts.<sup>1</sup> Many practitioners feared that such covenants were becoming extinct as a valid tool to protect employers' interests after the Arizona Supreme Court issued its decision in *Valley Medical Specialists v. Farber*.<sup>2</sup>

In that case, a non-compete provision in a physician's employment contract essentially pre-

vented the physician from practicing medicine anywhere in the Phoenix metropolitan area for a period of three years. Ruling that the geographic scope of that provision was too broad, the Court refused to enforce the covenant. The *Farber* Court clearly distinguished between the propriety of covenants not to compete in physician employment contracts, which raise serious public policy concerns, and those in the commercial context. Despite this distinction, however, no case law had addressed the enforceability of a covenant not to compete in the commercial context since *Farber*, and it was unknown whether such covenants would similarly be disapproved by our courts.

an examination of its duration and geographic scope. Neither of these elements may be any more broad than that necessary to protect a legitimate business interest of the employer.<sup>5</sup> But the concept of “reasonable geographic scope” has been transformed by *Bed Mart v. Kelley* into a rule of “reasonable competition” necessitated by today’s specialty and niche markets. Under *Bed Mart*, the geographic scope of a non-compete provision is less important when the provision carves out a specialty market within that geographic scope. We believe that the *Bed Mart* rule could have far-reaching ramifications in today’s world of global markets made possible by the Internet.

### *BED MART*—The Major Competitor Preclusion Rule

In *Bed Mart*, Kelley, a salesman working for the prominent mattress specialty store, was hired away by an arch competitor. Kelley had signed a “Covenant Not To

of a three-judge panel, Division One of the Court of Appeals overruled the trial court, finding that the “carving out” of *Bed Mart*’s major competitors limited the reach of the non-compete provision, allowing Kelley to find employment as a salesperson, even of similar products, at hundreds of stores that were not precluded by the provision. The court also held that the six-month duration of the provision was fair based on (1) *Bed Mart*’s need to protect its trade secrets from use by Kelley (whether intentionally or inadvertently—the “inevitable disclosure doctrine”) or by Kelley’s new employer, and (2) the amount of time it takes *Bed Mart* to train a new employee and to determine that employee’s effectiveness.

The rule has been that a covenant not to compete in an employment agreement is “valid and enforceable by injunction when the restraint does not exceed that reasonably necessary to protect the employer’s business, is not unreasonably

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In the past year, however, Division One of the Arizona Court of Appeals handed down a pair of decisions dealing with covenants not to compete. These opinions indicate that the court has

- restored and defined the use of covenants not to compete as a legitimate tool for protecting an employer’s interest in the prevention of unfair competition by departing employees<sup>3</sup>
- emphasized the need for employers to carefully draft non-compete provisions through the court’s refusal to rewrite overly broad restrictions in order to make them enforceable.<sup>4</sup>

Historically, the reasonableness of a non-compete provision typically turned on

Compete and Maintain Confidentiality of Trade Secrets of Employer” upon being hired by *Bed Mart*. In addition to prohibiting Kelley from disclosing *Bed Mart*’s trade secrets, the non-compete provision prohibited Kelley from obtaining employment with “any business for which the sale of mattresses accounts for more than fifty percent (50%) of sales revenue, for a period of six months following termination” of Kelley’s employment with *Bed Mart*.<sup>6</sup>

The trial court ruled that the geographic scope of the non-compete provision was overly broad, and that “carving out” a specialty could not save the provision. However, in a unanimous decision

restrictive of the rights of the employee, does not contravene public policy, and is reasonable as to time and space.”<sup>7</sup>

Our courts have found restrictive covenants to be reasonable and enforceable when they protect some legitimate interest of the employer beyond the mere interest in protecting itself from competition. Examples include preventing “competitive use, for a time, of information or relationships which pertain peculiarly to the employer and which the employee acquired in the course of the employment.”<sup>8</sup> Another protectable legitimate interest of an employer is having a “reasonable amount of time to overcome the former employee’s loss, usually by hiring

a replacement and giving that replacement time to establish a working relationship.”<sup>9</sup>

## BED MART’S LEGITIMATE INTERESTS

Bed Mart had several legitimate interests buttressing its covenant not to compete. Its chief concern was the access that each of its salespersons had to the company’s confidential information containing wholesale prices, promotional deals from suppliers and upcoming marketing strategies (its “Product Bible”). Salespeople are provided this information because they are permitted to negotiate the prices on the mattresses with customers. Because mattress “superstores” such as Bed Mart engage in a highly competitive business, Bed Mart could not afford to allow its five or six major competitors to have this information, and it believed disclosure would be inevitable if its former employees worked for its competitors.

For example, a former Bed Mart employee working elsewhere could preempt an upcoming Bed Mart product promotion or underbid a Bed Mart price. Bed Mart argued, and the court of appeals agreed, that use or disclosure of such information was inevitable, given the highly competitive nature of the industry and the desire for employees to make sales.

Kelley asserted that the geographical scope (within a 10-mile radius from any Bed Mart store) was unreasonable because, due to the placement of Bed Mart stores in the Phoenix area, Kelley was essentially precluded from selling mattresses in the entire Phoenix metropolitan area.

On its face, this argument would seem compelling. But, as noted previously, Bed Mart’s non-compete provision prohibited Kelley’s employment only with specifically defined major competitors at which Kelley’s knowledge would give him, and his new employer, an unfair advantage. The non-compete did not prohibit Kelley from working in his chosen field of employment, as he could work at hundreds of furniture and bedding stores in the Phoenix area. “Alternatively, Kelley could have applied his sales training to a

variety of other products because the covenant only precluded him from working at a business deriving most of its revenue from the sale of mattresses.”<sup>10</sup>

The court concluded, “The limitation to mattress stores reasonably restricts the effective scope of the covenant. Because of that limitation, Kelley was not precluded from obtaining employment in his specific area of sales expertise in the Phoenix area. Therefore, the non-compete provision was reasonable and should have been upheld.”<sup>11</sup>

The *Bed Mart* court also addressed the issue of the duration of the competitive restriction, finding its six-month provision reasonable for at least two reasons. First, it takes approximately six months for Bed Mart to hire and train a new employee to be profitable for the company. Second, Bed Mart revises its Product Bible with new merchandise, cost and promotional information approximately every six months—thereby rendering somewhat obsolete any information a former employee may have gleaned from the Product Bible after six months have elapsed from the employee’s termination of employment at Bed Mart.

Perhaps as important as any other issue was the court’s finding that there was no public policy issue involved because Kelley was not precluded

from continuing to engage in his chosen employment, the sale of mattresses—or other bedding or furniture, in the Phoenix metropolitan area. ... Further, the same public policy concerns are not inherent in this case as in cases involving non-compete restrictions on certain professions such as medicine in which issues regarding patients’ rights to free choice of care come into play.<sup>12</sup>

## THE LOGICAL EXTENSION OF THE BED MART RULE

At oral argument, *Bed Mart* argued that a non-compete provision containing a “major competitor” preclusion could render geographic limitations irrelevant; essentially, the purpose of limiting the geographic reach of the non-compete—the “where”—became replaced by “who.” In

other words, the consideration is no longer in what city (or state) the employee may work, but *for whom*.

The *Bed Mart* court seemed to acknowledge this in its holding: So long as the employee may find employment in his or her chosen line of work and in the same geographic area as the former employer, a non-compete provision containing a broad geographic range limited to only specific competitors is enforceable. Under this argument, it should not matter where the “prohibited” employers are located as long as there are a sufficient number of “permissible” employers within the employee’s desired working area.

Based on the clear holdings in *Bed Mart*, Arizona employers can rest assured that reasonable non-compete agreements are still valid and enforceable to provide protection from unfair practices of departing employees.<sup>13</sup> Furthermore, by carving out legitimate major competitors posing an unfair threat to the former employers, those competitors are precluded from cherry-picking valuable employees for the purpose of gaining an unfair advantage in the marketplace.

It will be essential, however, to carefully define “major competitor,” as the *Bed Mart* provision did, and to ensure that the threat of unfair competition that would arise from the employment of a former employee is legitimate. And careful definition is the subject of the court’s second major case in the area of covenants not to compete.

## VARSITY GOLD V. PORZIO—THE BLUE PENCIL RULE

In *Varsity Gold*, the court of appeals struck down a non-compete provision that was overly broad both in geographic scope and in duration. The covenant prohibited the employee from “competing with Varsity in ‘the State of Pennsylvania or any contiguous state.’”<sup>14</sup> The covenant also contained a provision permitting the court to “reform the geographic and time restrictions if it finds them to be unreasonable and unenforceable.”<sup>15</sup> The trial court found the covenant to be unenforceable

and, according to the parties' agreement, amended the geographic scope to the south Pittsburgh area and the duration to one year, pursuant to the provisions of the covenant.<sup>16</sup>

The court of appeals disapproved, relying on *Farber* in noting that “[b]y simply authorizing a court to rewrite unreasonable restrictions, an employer may relieve itself of crafting a reasonable restriction with the added benefit that departing employees may adhere to an onerous covenant.”<sup>17</sup> Thus, the court of appeals ruled that the trial court’s rewriting of the covenant was in error. In so holding, the court of appeals left no doubt that courts will not modify unreasonable covenants: “Any judicial reformation of a restrictive covenant beyond implementation of the ‘blue pencil’ rule is a ‘significant’ modification of the provision that cannot be tolerated.”<sup>18</sup>

The limits of the “blue pencil rule” are described in *Farber*: “Although we will tolerate ignoring severable portions of a

covenant to make it more reasonable, we will not permit courts to add terms or rewrite provisions.”<sup>19</sup>

Thus, practitioners and employers must be careful to draft reasonable and enforceable covenants in the first place, as courts will not modify such agreements even if the agreement contains a severance or modification clause. Employers must be careful to strictly analyze their “legitimate business interests” and to craft non-compete provisions that do nothing more than protect those interests for a reasonable time.

## CONCLUSION

The *Bed Mart* ruling has accomplished at least two purposes in the area of covenants not to compete.

- First, it has affirmed that properly drafted non-compete provisions remain a legitimate tool for protecting employers from unfair competition that can result when an employee leaves.

- Second, the *Bed Mart* case has shifted the focus on the geographic scope of a non-compete provision to permit employers to carve out specialty stores or businesses within a relatively broad geographic region who are legitimate major competitors to which the covenant applies, provided that there are other employers for whom a departing employee can work.

The fact that it applies to only a handful of potential employers out of hundreds (or thousands) of others is what makes it enforceable.

We think the implications of this ruling are significant and that, under proper conditions, the preclusion could even reach globally through the Internet or other communications technologies that permit businesses to operate worldwide. Provided the employer has legitimate protectable interests, a departing employee may be prohibited from working for a few major competitors to whom the trade secrets would have value. We think this represents a para-

dig shift in the rules of unfair competition in the employer–employee relationship. ▀

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## endnotes

1. See, e.g., *Valley Medical Specialists v. Farber*, 982 P.2d 1277, 1284–1285 (Ariz. 1999), discussed *infra*; *Olliver/Pilcher Ins. Co., Inc. v. Daniels*, 715 P.2d 1218, 1220 (Ariz. 1986) (statewide scope and three-year time period held to be overbroad); *Varsity Gold, Inc. v. Porzio*, 45 P.3d 352 (Ariz. Ct. App. 2002) (non-compete provision covering “the State of Pennsylvania or any contiguous state” for a period of three years held unenforceable); *Bryceland v. Northey*, 772 P.2d 36 (Ariz. Ct. App. 1989) (three-year time period held to be overly broad).
2. 982 P.2d 1277 (Ariz. 1999). This case was discussed at length in Hon. Robert L. Gottsfeld & Timothy D. Keller, *Thou Shall Not Prohibit a Former Employee From Earning an Honest Living*, ARIZ. ATTORNEY, August/September 2000, at 35.
3. *Bed Mart v. Kelley*, 45 P.3d 1219 (Ariz. Ct. App. 2002).
4. *Varsity Gold, Inc.*, 45 P.3d at 352.
5. *Farber*, 982 P.2d at 128, quoting Harlan M. Blake, *Employee Agreements Not to Compete*, 73 HARV. L. REV. 625, 647 (1960).
6. *Bed Mart*, 45 P.3d at 1220.
7. *Phoenix Orthopaedic Surgeons, Ltd. v. Peairs*, 790 P.2d 752, 755 (Ariz. Ct. App. 1989), disapproved on other grounds, *Farber*, 982 P.2d at 1277.
8. *Farber*, 982 P.2d at 1281 (quoting Blake, *supra* note 5, at 647).
9. *Id.* at 1284 (quoting Blake, *supra* note 5, at 659).
10. *Bed Mart*, 45 P.3d at 1225, n.5.
11. *Id.* at 1223, citing *Peairs*, 790 P.2d at 758; see also *Farber*, 982 P.2d at 1284–1285.
12. *Bed Mart*, 45 P.3d at 1223, citing *Farber*, 982 P.2d at 1282–1283.
13. It bears noting that some jurisdictions change their analysis of non-compete provisions depending on the method of the employee’s termination. See generally Kenneth J. Vanko, “You’re Fired! And Don’t Forget Your Non-Compete ...”: *The Enforceability of Restrictive Covenants in Involuntary Discharge Cases*, DEPAUL BUS. & COM. L.J., Fall 2002, at 1. Thus far, however, Arizona courts have not distinguished non-compete provisions on that basis. See, e.g., *Olliver/Pilcher Ins. Co.*, 715 P.2d at 1219 (employer terminated employee’s employment); *Varsity Gold, Inc.*, 45 P.3d at 353 (plaintiff terminated contract with defendant).
14. *Varsity Gold, Inc.* 45 P.3d at 353 (quoting the agreement).
15. *Id.*
16. *Id.* at 354.
17. *Id.* at 356.
18. *Id.* at 355.
19. *Farber*, 982 P.2d at 1286.