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Reminder to North Carolina Employers: Take Time to Thoughtfully Craft Your Restrictive Covenants!

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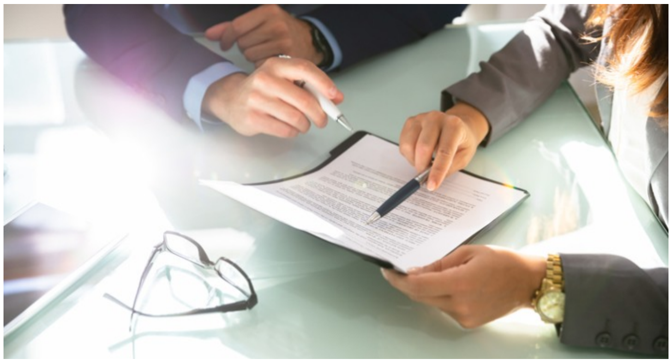

A recent decision of the North Carolina Court of Appeals serves as an important reminder to avoid the temptation to overreach when seeking to protect your customer relationships.

Restrictive covenants prohibiting competition and customer solicitation remain a valuable tool to protect your business; however, if not carefully crafted, they are doomed to fail when you need them most.

In *Sterling Title Co. v. Martin*, the plaintiff Sterling Title Company ("Sterling") sued its former employee and her new startup company for soliciting Sterling's customers in breach of her contractual agreement. Like many employers, Sterling wanted to protect its business by prohibiting the employee from interfering with its customer relationships. Thus, upon hiring the employee, Sterling had her execute an agreement stating:

> ...I also agree that for the period of my employment by the Company and for one (1) year after the date of termination of my employment with the Company I will not, either directly or through others: ...(c) solicit or attempt to solicit any customer or partner of the Company with whom I had contact during my employment with the Company to purchase a product or service competitive with a product or service of the Company...

In crafting this restriction, Sterling was smart in not trying to protect *all* customer relationships, which is a mistake many employers make. Courts generally will not enforce a restriction prohibiting contact with <u>all</u> customers because this theoretically would include customers the employee isn't familiar with and may not even know to exist. Under North Carolina law, a business has a legitimate business interest in prohibiting an employee from soliciting those customers with whom the employee has some prior connection which may create an unfair advantage; however, there is no legitimate business interest in prohibiting an employee from soliciting those customers with whom the employee has no connection. That's generally considered fair competition, which cannot be stopped. Sterling presumably recognized this limitation and, thus, only extended the restriction to those customers with whom the employee had "contact" during her employment.

Sterling also avoided another common mistake by stating that the employee was only prohibited from soliciting those customers *for competitive reasons*. You may think this is obvious and goes without saying; however, if not said, then that technically means the employee is prohibited from soliciting the customer *for any reason*, including reasons which are unrelated to the employer's business. To illustrate, a title company such as Sterling has no legitimate business interest in stopping an employee from soliciting its customers to provide landscaping services. Sterling recognized this and made sure to draft the restriction to only apply to competitive solicitation.

Finally, Sterling was smart in not trying to extend its restriction too far into the future. While many employers are tempted to impose multi-year restrictions on their employees, Sterling's restriction only applied for a period of one year following termination. In the world of restrictive covenants, a one-year restriction is relatively short, which generally helps when asking a court to enforce it.

For all of the above reasons, you may be thinking that Sterling prevailed in its lawsuit against the former employee. Unfortunately for Sterling, you'd be wrong because the Court of Appeals determined the covenant of non-solicitation was unenforceable as a matter of law. The reasoning underlying the court's decision demonstrates the importance of being thoughtful and precise when crafting your restrictive covenants.

First, the court noted that the Agreement did not define the phrase "customer or partner." Without a limiting definition, this phrase could be interpreted as applying to former customers, prospective customers, and even future customers of Sterling if the employee had some contact during employment. Moreover, the court noted that "customers" come in all shapes and sizes; thus, broadly prohibiting solicitation of a "customer" who may operate out of multiple offices throughout the country may be unreasonable if the employee only had contact with the local "customer" office in North Carolina.

Making matters worse, Sterling also failed to define the type of "contact" that was required to trigger the protection. Is it sufficient contact if the employee answered the telephone when the customer called? What if the employee encountered the customer on the elevator one day? Although that type of minimal contact likely was never contemplated when Sterling drafted its agreement, the restriction technically could be read to include it.

Finally, Sterling made one more major mistake when it failed to include a "look-back" period when defining the scope of customers covered by the restriction. In all likelihood, Sterling was only concerned with active customers and recent contact; however, the restriction did not reflect this. Instead, the restriction covered all "customers" with whom the employee had any "contact" during her employment; thus, read literally, this would include contact the employee had on her first day of employment. And, because the employee, in this case, had been employed with Sterling for ten years, the court reasoned that the covenant effectively restricted the employee from soliciting a customer who may have stopped doing business with Sterling nine years and 11 months earlier. In situations like this, courts in North Carolina will add the "look-back" period to the future restricted period in determining whether the total time limitation is reasonable. Following that approach in this case, the court determined that Sterling's one-year restriction was really an 11-year restriction when considering that the look-back period was the entire length of the employee's employment.

For all these reasons, the court determined that the agreement was "patently unreasonable" and dismissed Sterling's complaint. North Carolina employers may feel frustrated with this result and conclude that it is not worth having their employees execute restrictive covenants. This would be a mistake. Even under the strict requirements of North Carolina law, thoughtfully crafted restrictive covenants are enforceable and can be a very effective tool to protect your business. The lesson to be learned here is to avoid the temptation to overreach by painting with broad strokes; instead, figure out the type of activities that you truly need to restrict and narrowly tailor your covenants to only cover those activities. Investing the necessary time upfront to draft your covenants appropriately will pay off in the long run.

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