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Non-Competition Agreements

Issues with Enforcement and Validity

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Selecting, hiring, and training key employees requires a significant investment of time and resources. To protect that investment, many Colorado businesses require their employees to sign non-compete agreements as a condition to employment. Before doing so, there are certain things every business owner should know about non-competes in Colorado.

First, the non-compete must fall within one of four statutorily created exceptions.

Second, the non-compete must be limited in time and geographic scope.

Non-Competes are Generally Not Enforceable under Colorado Law

Pursuant to C.R.S. § 8-2-113, non-competition agreements are unenforceable under Colorado law unless they fall within one of the following four statutory exemptions: (1) A contract for the purchase and sale of a business or the assets of a business; (2) A contract for the protection of trade secrets; (3) A contract authorizing recovery for education and training expenses of an employee who has served the employer for less than two years; and (4) A contract with executive or management personnel and officers and employees who serve as professional staff to executive and management personnel.

If the non-compete does not fall within one of the four exemptions, it is void and is not enforceable.

Contracts for the Sale of Businesses

If the non-compete is entered into in connection with the sale of an entire business or all of the assets of a business, it will likely fall within this exception and be enforceable. However, the issue is unclear if less than the entire business is sold. For instance, would stock options, equity grants, or forced sales of minority interests meet this exception?

In *Boulder Medical Center v. Moore*, the Court of Appeals held that a physician's receipt of payment for his interests in a medical practice, partnership, and corporation was sufficient to bring the non-compete into the statutory exemption—even though he had not sold the entire practice outright. 651 P.2d 464 (Colo. App. 1982).

Similarly, in *Harrison v. Albright*, the Court of Appeals held that a lender making a loan to fund the start up of an electrical business was analogous to a sale of a business so as to fall within this statutory exemption. 577 P.2d 302 (1977). The *Albright* Court reasoned that the lender was in substance acting like a business owner—parting with a significant amount of money largely in return for the party's promise not to compete with the business.

If the non-compete does not fall within one of the four exemptions, it is void.

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While there is not a bright line rule for this exemption, the general purpose of this exemption is to safeguard the integrity of the sale of the business. If buyers of businesses could not prohibit sellers from starting competing companies, one of the core benefits of their bargain would be frustrated. With that in mind, Courts will likely focus their inquiry on whether the non-compete provides fair protection to buyers for the business or assets they have purchased.

Contracts for the Protection of Trade Secrets

Courts apply a two-step test to determine whether non-competes will fall within this exception. *Mgmt. Recruiters of Boulder, Inc. v. Miller*, 762 P.2d 763, 765 (Colo.App.1988).

First, the Court must examine the facts of the situation to determine whether the restrictive covenant is justified at all. *Id*.

Second, the Court must look to the specific terms of the non-compete to determine whether the effect is reasonable. *Id*.

To be enforceable, the provision must be narrowly drafted to only prohibit what is necessary to protect the trade secrets and nothing more. *Id*.

Thus, when drafting a non-compete under this exception, care should be taken to: (i) understand exactly what trade secrets require protection; and (ii) what prohibitions are necessary to protect the trade secrets.

What constitutes a trade secret is fact intensive and depends on the circumstances of each case. Courts generally require three elements for a trade secret to exist: (i) secrecy [the information must not be generally known to the public]; (ii) protective measures to ensure the secrecy [the trade secret owner must take reasonable steps to keep the information secret]; and (iii) value [the trade secret itself must have some inherent value]. Customer lists, pricing information, contracts, detailed debtor information, and client information have all been found to be trade secrets. Whether the information will constitute a trade secret will depend on each case and warrants a close analysis when drafting the non-compete.

Executives, Management, and Professional Staff

To fall within this exception, the contract must be with either: (i) executives or managers; or (ii) professional staff to executives or managers.

The determination of whether an employee qualifies as an executive, manager, or professional staff depends on many factors and will be decided by the trier of fact.

Generally, if an employee is in charge of a significant portion of the company's business, acts in an unsupervised capacity, and supervises other employees, the employee will qualify as a manager or executive for the purposes of this exception.

To qualify as professional staff for this exception, the individual must be a professional (through certification, knowledge, or experience), report to managers or executives, and primarily serve as a key member of the manager's or

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executive's staff in the implementation of management or executive functions. *Phoenix Capital, Inc. v. Dowell*, 176 P.3d 835 (Colo. App. 2007).

Limitations in Geographic and Temporal Scope

Assuming the non-compete falls within one of the above exceptions, it must also be limited in time and geographic scope. Colorado does not have an exact requirement for geographic and time limitations. Instead, Courts look to what is reasonable given the circumstances. A good rule of thumb is to try to prohibit as little as possible while still protecting the core of what you want protected. If a 12 month prohibition in a certain geographic area would work for your needs, opt for that instead of a multi-year, nationwide prohibition. The more reasonable your restriction, the less likely a Court will find it unenforceable.

Special Rules Apply to Physicians

Special rules apply for non-competes involving physicians. Pursuant to C.R.S. § 8-2-113(3), covenants not to compete between physicians that restrict the right of a physician to practice medicine upon termination of the agreement are void. However, physicians can be obligated to pay liquidated damages on termination.

It is also important to note that the Colorado legislature just passed in 2018 an amendment to Section 113(3), which imposes certain limits on the ability to recover damages arising from the treatment of patients with rare disorders. A detailed analysis of this amendment is beyond the scope of this article. For any questions, please contact our office.