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John F. Reha[a1]

THE LAW OF TRADE SECRECY AND COVENANTS NOT TO COMPETE IN COLORADO—PART II

In Part I of this article, which appeared in the April 2001 issue,[1] the focus was on trade secrecy. In this Part II, attention shifts to the law relating to covenants not to compete. As in the area of trade secrecy, the past ten years have seen a marked increase in activity regarding non-compete covenants. Colorado law is somewhat unique in that, in 1973, the Colorado General Assembly enacted a statutory prohibition against most non-compete agreements.[2] The statutory prohibition is discussed in detail below, as well as the numerous cases that have arisen under the exceptions to the statute. This article also discusses the common-law factors that are still part of Colorado law regarding covenants not to compete, such as the rule of reasonableness for time and geographic restrictions. Finally, the article covers common drafting and litigation issues Colorado attorneys are likely to encounter.

PROTECTING GOODWILL

Covenants not to compete protect the legitimate interest in goodwill of an established business.[3] In turn, "(g)oodwill has no existence as property in and of itself, but rather is an incident of a continuing business having a particular locality or name."[4] Goodwill is "the expectation of continued and repeated public patronage."[5] When a business is liquidated, its goodwill ceases to exist, and a covenant not to compete that had been entered into to protect such business lapses as an unenforceable restraint of trade.[6]

Non-compete covenants are agreements that prohibit one or more persons or entities from competing with another, usually in a defined territory, for a set period of time. They may bar all competition or certain types of activities only, such as maintaining business relations with certain customers or co-employees. They arise most often in employment agreements,[7] but are also common in sale of business transactions.[8] On occasion, they are encountered in other contexts as well. For example, in *Harrison v. Albright*,[9] a covenant not to compete was included as part of the collateral securing a business loan. In *Marriage of Fischer*,[10] the Colorado Court of Appeals approved the imposition of a non-compete covenant in a divorce proceeding between a husband and wife who were also business partners. The business was awarded to the wife, while the husband was awarded cash equal to his half-interest. Finding that the husband was intricately involved in management, the covenant was imposed by the trial court in order to protect the business's viability.

THE COLORADO STATUTE AND EXCEPTIONS

In Colorado, a discussion of covenants not to compete in current practice must begin with a review of CRS § 8-2-113(2), which provides as follows:

> Any covenant not to compete which restricts the right of any person to receive compensation for performance of skilled or unskilled labor for any employer shall be void, but this subsection (2) shall not apply to:
>
> (a) Any contract for the purchase and sale of a business or the assets of a business;
>
> (b) Any contract for the protection of trade secrets;
>
> (c) Any contractual provision providing for recovery of the expense of educating and training an employee who has served an employer for a period of less than two years; and
>
> (d) Executive and management personnel and officers and employees who constitute professional staff to executive and management personnel.

From its express language, it is clear that § 113(2) generally provides that covenants not to compete are void. Covenants that do not meet one of the exceptions are void *ab initio*.[11] It is only through one of the exceptions set forth in subsections (2)(a) through (d) that a covenant not to compete may be enforceable in Colorado. The exceptions accordingly form much of the basis of the practice of law in Colorado regarding covenants not to compete. The exceptions to the rule of invalidity set forth in subsections (2)(a), (c) and (d) are examined below. The "trade secrets" exception ***6** of subsection (2)(b) was discussed in Part I of this article.[12]

Business Sales: CRS § 8-2-113(2)(a)

Under subsection (2)(a) "contract(s) for the purchase and sale of a business or the assets of a business" are exempt from the rule of invalidity.[13] By its terms, subsection (2)(a) exempts both stock and asset acquisitions. Accordingly, all transactions in which the entirety of the stock or assets of a business are sold are exempt. In *Boulder Medical Center v. Moore*,[14] the Court of Appeals applied the sale of business exception to, what at least appears to be, the sale of a minority ownership position under the "buy-sell" provisions of an agreement between shareholders of a group medical practice. In *Albright*,[15] the court applied the sale of business exception by analogy to a situation where a private investor loaned start-up capital to an electrical contracting concern. One of the principals of the business elected to resign and open a competing contracting firm. The court affirmed the enforcement of a covenant not to compete contained in the collateral provisions securing the loan, noting that such situation was akin to the sale of a business.[16]

Although the express terms of subsection (2)(a) look to the "sale and purchase of a business or the assets of a business," it is uncertain whether Colorado would apply the sale of business exception to a situation in which compensation is given to an employee in the form of ownership of a minority interest in the company seeking enforcement (as with stock bonuses). However, it does appear that the exception will be enforced, as in *Moore*,[17] when a key principal in a closely held concern sells his or her ownership interest back to the entity or other principals.

A "sale" may also be imposed. In *Marriage of Fischer*,[18] a divorce court imposed a covenant not to compete against a husband when it awarded the divorcing couple's business to the wife. The Colorado Court of Appeals found "the transfer of a business interest to one spouse as part of the disposition of property in a dissolution action is analogous to a sale of the business and, therefore, falls within the exception of § 8-2-113(2)(a)."[19] Although covenants not to compete are disfavored in Colorado and the exceptions are accordingly narrowly construed, those arising under the sale of business exception will be construed more liberally than those arising out of employment relationships.[20]

Trade Secrecy Agreements: CRS § 8-2-113(2)(b)

This exception was discussed in detail in Part I of this article.[21]

Education and Training Expense Recoupment: CRS § 8-2-113(2)(c)

Although this provision is set forth as an exception to the general rule of invalidity of covenants not to compete, it does not necessarily relate to such agreements. In practice, this "exception" allows employers to recoup expenses of training and education for employees who have been employed less than two years at termination.[22] Recoupment of such expenses will be allowed, however, only where an agreement expressly providing for such recoupment exists between the employer and employee.[23]

Executives, Managers, And Professionals: CRS § 8-2-113(2)(d)

Under subsection (2)(d), covenants with those persons who qualify as executive or management personnel or "professional staff to management" are exempt from the general rule of invalidity. The determination of whether an employee is a manager or executive is an issue of fact.[24] Generally, if an employee is "in charge" of a significant portion of the plaintiff's business or other employees and/or if such person "act[s] in an unsupervised capacity," such person will fall within the exception.[25] The U.S. District Court for the District of Colorado has stated that "(t)o be part of the group 'executive and management personnel' an employee must have significant responsibility for the business and act in a supervisory capacity."[26]

Cases making determinations as to inclusion of an employee within the management, executive, and professional exception include *Marriage of Fischer*,[27] where the husband/business partner was "in charge of" a photo finishing business, and *Albright*,[28] where the partner in an electrical contracting business "was the only person who possessed the knowledge, skills, and the licenses to make the business a possible success" and was therefore "the key man and very heart of the business."

In *Atmel Corp. v. Vitesse Semiconductor Corp.*,[29] decided in February 2001, the Court of Appeals found unsupported by the evidence a conclusion reached by the trial court that a certain "technical liaison" employee who left to join a competing venture came within the management, executive, or professional exception. After noting that the exception "applies to those employees who are 'in charge' of the business and who act in an unsupervised manner,"[30] the court found that the employee in question did not supervise any other employees and, in fact, had three levels of management above him.[31] Moreover, in *Management Recruiters of Boulder, Inc. v. Miller*,[32] the Court of Appeals found that an "account executive," who the court determined to be primarily an "information gatherer," was not a manager or executive.[33]

The other portion of the subsection (2)(d) exception applies to "professional staff to executive and management personnel." The Court of Appeals has applied the exception for "professional staff" to "such persons as legal, engineering, scientific and medical personnel together with their junior professional assistants."[34] Therefore, it would seem that some tie to a true learned profession may be required for the "professional staff" exception to apply.

In this regard, it is doubtful that this portion of the exception would apply to such quasi-professionals as insurance salespersons, financial planners, real estate salespersons, and stockbrokers. "Junior professional assistants," however, are included within the "professional staff" exception.[35] Thus, nurses and therapists probably fall within the exception. In *Occusafe, Inc. v. EG&G Rocky Flats, Inc.*,[36] the Tenth Circuit Court of Appeals held that at least a fact issue existed as to whether certain "industrial hygienists" working at Rocky Flats constituted professional staff under subsection (2)(d).

To be a member of a plaintiff's "professional staff," a person may need to be an employee. In *Smith v. Sellers*,[37] a dentist who associated with another dentist's practice on an independent contractor basis was found not to be on the other dentist's "staff." The Court of Appeals determined that, as an independent contractor, the dentist could not be included within the professional staff exception. This "staff" limitation probably refers to "professionals" only.

Physicians as Professional Staff

Physicians were determined to be "professional staff" under subsection (2)(d) in the *Moore* decision.[38] In *Moore*, the defendant-physician was prohibited under subsection ***8** (2)(d) from practicing in Boulder County under a covenant in his employment agreement, which in turn was tied to a "buy-sell" agreement he entered into as a partner in a Boulder family practice. However, the General Assembly, shortly after *Moore* was decided, elected to render void any covenants that bar a physician from practicing in any given location. The General Assembly did allow for certain damages provisions in the event of such post-termination competition. Its amendment, codified as CRS § 8-2-113(3), reads as follows:

> Any covenant not to compete provision of an employment, partnership, or corporate agreement between physicians which restricts the right of a physician to practice medicine, ... upon the termination of such agreement, shall be void; except that all other provisions of such an agreement enforceable at law, including provisions which require the payment of damages in an amount that is reasonably related to the injury suffered by reason of termination of the agreement, shall be enforceable. Provisions which require the payment of damages upon termination of the agreement may include, but not be limited to, damages related to competition.

Thus, subsection (3) creates a special rule only for "physicians" who are "practicing medicine." It is doubtful that subsection (3) will be applied to cover anyone other than M.D.S and osteopathic physicians (osteopaths are engaged in the practice of medicine under Colorado licensing provisions).[39]

Problems have been encountered in gaining a workable damages formula under the special provision within subsection (3) that allows for damages "reasonably related to the injury suffered." In *Wojtowicz v. Greeley Anesthesia Services, Inc.*,[40] an anesthesiologist's employment agreement with a medical group professional corporation provided that any physician who terminated and went into competition was obliged to pay the corporation $10,000 for losses to its goodwill. The terminating physician would also be requested to pay the corporation 50 percent of all fees earned by him or her in the two years following termination. The defendant doctor's employment was terminated, and the doctor opened his new practice within the geographic area giving rise to the obligation to pay such amounts.

The corporation sued, seeking recovery under each of the two contractual provisions. The Court of Appeals invalidated both provisions as not approximating the injury to the corporation that would be "reasonably related to the injury suffered" because of the defendant's competition, as required by subsection (3). The provision calling for forfeiture of 50 percent of the defendant's income in the first two years following termination was invalidated because it was based on the defendant's gross income, which was not commensurate with the corporation's expected lost profits—the court found lost profits to be the measure of injury reasonably related to the defendant's competition.[41] In addition, the court found that the 50 percent provision was "as a matter of law ... disproportionate to any possible loss incurred by [the corporation and] [t]hus ... an unenforceable penalty at common law."[42]

The $10,000 "goodwill" provision also was invalidated as disproportionate to any injury that would be reasonably related to the defendant's competition and therefore a penalty as a matter of law.[43] Further, the court found support in the record for the trial court's conclusion that the plaintiff established no loss to its goodwill, the asset to which the $10,000 damages provision was tied.[44] The court determined that the corporation had the burden of proving the validity of both damages provisions.[45]

Although no appellate decisions approving specific damages provisions in an agreement exist under subsection (3), some guidance is provided by cases determining the validity of liquidated damages provisions arising under competition restrictions involving persons other than physicians.[46] To be enforceable, a liquidated damages clause must meet a two-part test. First, the plaintiff must show that potential damages are difficult to ascertain at the time the contract is executed. Second, the liquidated damages clause must include a reasonable attempt at estimating damages that are not severely disproportionate to the damages that are probable in the event of breach.[47]

It should be noted, however, that *Wojtowicz* requires any computation of an amount to be paid by a competing physician under subsection (3) to be "measured by the loss of net profits, meaning net earnings or the excess of returns over expenditures, but not lost gross profits or gross sales revenues."[48] Because subsection (3) clearly assumes that the provision will need to be predictive as to damages, it is likely that a workable method of providing for anticipated net profits will be found and approved if it is tied to some real measure of net profit losses.

Lawyers and Ethical Concerns

Attorneys clearly are included within the description "such persons as legal, engineering, scientific and medical personnel together with their junior professional assistants,"[49] and are therefore "professionals" within subsection (2)(d). Although a review of subsection (2)(d) and the relevant case law would lead to a conclusion that covenants not to compete between attorneys are enforceable,[50] ethical considerations place great doubt on their validity. Rule 5.6 of the Colorado Rules of Professional Conduct ("Colo.RPC") provides:

> A lawyer shall not participate in offering or making:
>
> (a) A partnership or employment agreement that restricts the right of a lawyer to practice after termination of the relationship, except an agreement concerning benefits upon retirement or as permitted in Rule 1.17; or
>
> (b) an agreement in which a restriction on the lawyer's right to practice is part of a settlement of a controversy or suit.

Colo.RPC 1.17(f) allows lawyers to agree as part of a purchase of an attorney's practice that the sale of the practice's goodwill "may be conditioned upon the seller ceasing to engage in the private practice of law for a reasonable period of time within the geographical area in which the practice had been conducted." Thus, covenants not to compete between lawyers are probably enforceable only in the narrow area of one attorney selling his or her practice to another.

Application to Self-Employed Persons

CRS § 8-2-113(2) begins, "Any covenant not to compete which restricts the right of any person to receive compensation for performance of skilled or unskilled labor *for any employer* shall be void ...." (*Emphasis added*.) Although this rule of prohibition appears to invalidate only those covenants not to compete that restrict a person in performing labor "for any employer," the Court of Appeals also has applied the above language to attempts to enforce such covenants against individuals who compete as self-employed persons.

In *Management Recruiters of Boulder, Inc.*,[51] the court stated that the focus of subsection (2) is to prohibit persons from interfering with the "*right* of any person to receive compensation for performance of skilled or unskilled labor," regardless of whether the person is working for another ***9** or is self-employed.[52] Accordingly, individuals entering into competition as self-employed persons also are protected by subsection (2)'s rule of prohibition.

Independent Contractors

CRS § 8-2-113(2)'s rule of prohibition applies to independent contractors. In *Colorado Supply Co. v. Stewart*,[53] the court stated that the trial court did not err in invalidating the non-competition covenants in the parties' contract.[54] This determination appears to be in full accord with the language of subsection (2), as the statute protects persons who have signed non-compete agreements from interference with their *post*-termination employment. Thus, whether a person's pre-termination occupation is in the form of an independent contractor or employee would appear irrelevant. It should be remembered, however, that pursuant to *Smith v. Sellers*,[55] independent contractors may not be considered to be "staff" for purposes of the "professional staff" portion of the management, executive, and professional persons exception in CRS § 8-2-113(2)(d).

No Statute of Frauds Requirement

CRS § 8-2-113(2) does not require non-compete covenants to be in the form of a signed written agreement. In *Gold Messenger, Inc. v. McGuay*,[56] the Court of Appeals approved the imposition of injunctive relief against a person in a close personal relationship with another who was party to a written franchise agreement containing a non-competition provision. Although the statute does not itself require a written agreement, it may be difficult for a plaintiff to establish the existence of a noncompetition agreement unless such an agreement is in writing. Further, although *McGuay* did not feature a signed, written agreement entered into by the defendant, such an agreement did exist with the person with whom the defendant had this relationship.[57]

Cumulative Remedies Permitted

Because the special physician's rule of CRS § 8-2-113(3) was enacted after the *Moore* decision, remedies in that case were not limited to the liquidated damages remedy specified in subsection (3). The trial court in *Moore* enjoined the defendant from practicing medicine within the restricted zone and further awarded the plaintiff damages incurred because of the defendant's competition. The defendant asserted that imposition of both legal and equitable remedies was unsupported by the law. The Court of Appeals affirmed the award of money damages and injunctive relief, however, finding them to be acceptable cumulative remedies.[58] This dual remedy aspect of the *Moore* decision likely applies to all enforceable covenants not to compete that provide for cumulative remedies.

ACTS CONSIDERED COMPETITION

One issue that can arise in the context of non-compete agreements is whether certain conduct constitutes competition such that anti-competitive provisions of an agreement apply. In *National Propane Corp. v. Miller*,[59] the owner of a retail propane business entered into a covenant not to compete as part of the sale of such business, which prohibited the owner from owning any interest in a competing company or working or consulting for any such entity, directly or indirectly. During the covenant period, the seller assisted some relatives for a short time in entering into the retail propane business by ordering equipment, loaning money, leasing real estate, and providing general assistance, all for no compensation. The trial court, noting that the seller's assistance to the competing venture was of short duration, for no compensation, and of little substantive benefit, found that such activity did not violate the covenant.

The Court of Appeals disagreed, finding that the covenant contained broad language that went beyond mere employment of the seller in the propane business and that the seller did indeed materially breach the covenant, at least as to some of his acts. The agreement barred the seller from "working for" a competitor in any fashion, directly or indirectly. Thus, providing general services to the competing venture was deemed to be in violation of the covenant. Because the agreement did not prohibit the seller from loaning money or leasing real estate to the competitor, such conduct fell outside the agreement and was found not to be in breach of the covenant.[60]

In reaching its conclusion, the court noted that "(t)he proper test for determining whether a breach is material is to look at the substantial benefit that the *injured party* (purchaser) would have obtained from the fulfillment of the contract, not whether a third party has obtained a substantial benefit from the breach" (*emphasis in original*).[61] The court did specify that ***10** the portion of the seller's conduct found to be in breach of the agreement constituted a breach only through the end of the covenant period. Any assistance provided by him to the competing venture after his covenant expired did not constitute a breach.[62]

THE RULE OF REASONABLENSS

Colorado also applies the "rule of reasonableness" to covenants not to compete. Under this rule, a non-compete covenant must be reasonable as to both time and territory. Accordingly, even those covenants that are not invalidated by CRS § 8-2-113(2) must be reasonable to be enforceable. In applying this rule, the court is first to examine the factual situation to determine whether a restrictive covenant is justified. Second, the trial court must determine if the specific terms of the noncompetition agreement are reasonable.[63] Reasonableness is required as to scope, duration, and geography.[64] What is reasonable depends on the facts and circumstances of each case.[65]

Time and Geography

Although the period during which a non-compete agreement is in effect must be reasonable and not impose undue hardship, an acceptable period for the running of a covenant not to compete depends on the circumstances of each case.[66] No set time periods for non-competition provisions have been noted in Colorado as acceptable, although covenant periods of up to five years have been routinely enforced.[67] Regarding geographic scope, no set rule has been established as to what is reasonable, but the scope of the restriction should be no wider than is necessary to afford the required protection.[68] A court likely will examine the geographic nature of the business at issue in determining geographic reasonableness.

Covenants with specific geographic and time restrictions have been enforced by the Colorado appellate courts, ranging from small areas to the entire state of Utah and from one year to seven years.[69] Covenants with no time limits are deemed unenforceable.[70] Trial courts have the discretion to modify unreasonable territorial restrictions.[71] In the case of *Gulick v. A. Robert Strawn & Assoc.*,[72] a covenant restricting competition within thirty-five miles of any of the plaintiff's offices was deemed excessive and was redrawn to within ten miles of the City and County of Denver. Although courts may reform duration and geographic restrictions in covenants not to compete, they are not required to do so.[73] Moreover, they may refuse to impose missing geographic restrictions.[74] For a trial court to reform an agreement of non-competition, it must find that the duration or geographic limitation is unreasonable.[75] On the other hand, a court is not likely to increase the term of a covenant not to compete.[76]

Scope

The limitations on the activities sought to be restricted must be reasonable in their scope. The limitation should not restrict an employee from activities unrelated to the former employment. Accordingly, the limitations must not impose undue hardship and be no wider than necessary to protect the legitimate business interests of the party in whose favor the covenant applies.[77]

OTHER FORMATION AND ENFORCEMENT ISSUES

In Colorado, even for those covenants not to compete that are valid under CRS § 8-2-113(2) and are reasonable in time, geography, and scope, other issues may greatly impact enforceability. These have to do with formation concerns, such as the lack of duress, the need for consideration, abandonment and waiver, prior breach, and future events in the life of the entity protected by the covenant. Such issues are discussed in the following section.

Duress

In Colorado, contracts are voidable if assent is induced by an improper threat that leaves no reasonable alternative.[78] Colorado has adopted *Restatement (Second) of Contracts* § 176 (1981). Under § 176(1), threats are improper if what is threatened is a crime or a tort, a criminal prosecution, a bad faith threat of use of civil process, or a breach of the duty of good faith and fair dealing. Under § 176(2), a "threat is improper if the resulting exchange is not on fair terms, and ... the threatened act would harm the recipient and would not significantly benefit the party making the threat," if "the effectiveness of the threat in inducing the manifestation of assent is significantly increased by prior unfair dealing by the party making the threat, or ..." if "what is threatened is otherwise a use of power for illegitimate ends."[79]

Economic threats, such as threats to blacklist an employee, constitute duress, rendering an employment contract executed under such threats ineffective.[80] Contracts entered into under duress are not void, but merely voidable (that is, they are effective unless and until challenged).[81]

Consideration

All contracts, including covenants not to compete, must be supported by valid consideration.[82] A specific question arises as to whether the mere continued performance of existing employment duties constitutes consideration. In Colorado, "[a]lthough a promise to perform an existing obligation does not constitute consideration,[83] if the existing legal duty which one promises to perform is either 'doubtful' or the subject of honest dispute," it can constitute consideration.[84]

No Colorado decision deals directly with the issue of whether continued performance of pre-existing employment duties would support a covenant not to compete. In *Simko, Inc. v. Graybar Co.*,[85] however, the Maryland Court of Appeals held that continued performance of employment duties was sufficient to support a non-competition covenant under Maryland law.

Consideration Issues in Sale Of Business Transactions

The issue of consideration merits special attention in a sale of business situation. If an acquisition is orchestrated through a sale of stock, the transaction will occur solely at the shareholder level, while a sale of assets is a direct sale of the property of the business entity itself. Such a transaction is conducted at the corporate, not shareholder level. This distinction creates two compelling issues as to non-compete agreements (and all other employment-related contracts for that matter, including trade secrecy non-disclosure agreements), first as to the existence of consideration and second as to continued enforceability of agreements in existence prior to closing.

Because a sale of stock is accomplished at the shareholder level only, nothing from a practical perspective changes as to the ongoing business of the entity itself. For instance, if the shareholders of ABC, Inc. sell all of their stock to a new owner, such sale has no effect on the agreements to which ABC is a party (unless such agreements specifically so provide). ABC remains intact, its ongoing business relationships remain in place, and nothing changes except that ABC's stock now has a new owner. As a result, existing non-compete agreements (as well as existing trade secrecy agreements and other agreements ***11** with personnel) remain in force, unchanged by the deal. Thus, barring express language to the contrary, those covenants not to compete entered into prior to the sale of stock remain intact and remain enforceable to the same extent as before the stock sale.

Obtaining new covenants tied to the closing of a stock acquisition creates a problem as to consideration. Because the employment relationship between the company and its employees is the same the moment before and the moment after closing, no consideration, aside from continued performance of a pre-existing employment duty, will exist to support new restrictions on employees, including competition limitations. Colorado law makes the existence of sufficient consideration to support such new restrictions uncertain on such continued performance only.[86] Therefore, a promotion, increase in pay, stock bonus, or some other form of independent consideration may be needed to ensure that new covenants are enforceable.

The opposite issues and opportunities arise in the event of an asset acquisition. The old employer ceases to exist at closing because the transaction is directly between the purchaser and the entity operating the business (in fact, the seller may dissolve shortly after closing). Accordingly, unless specific language allowing assignment of an existing covenant not to compete is set forth in the covenant, the closing will likely cause the covenant to terminate.[87]

Asset transactions, however, present a better opportunity for effective post-closing covenants to arise. Again, the employer will change once the new owner acquires the assets and begins to conduct business. Hence, upon closing, all employees who are being retained by the purchaser will have a new employment relationship with a new employer—all employees being carried over will, in legal reality, be hired anew. This, in itself, is sufficient consideration to support new competition restrictions (as well as any other lawful restriction, such as trade secrecy non-disclosure agreements).[88] The suspect form of consideration presented by the mere continued performance of a pre-existing employment relationship will not be present.

Abandonment and Waiver

Abandonment of an agreement may arise by the parties' subsequent agreement or by the parties' conduct.[89] No reported Colorado cases exist, however, on waiver of the right to enforce a covenant not to compete.

Business Termination

A covenant not to compete cannot be enforced if the ex-employer ceases business.[90] However, a properly assignable covenant sold as a business asset is enforceable.[91]

Layoffs

No Colorado case exists on point. However, New York courts have held that public policy prohibits enforcement of a covenant not to compete when the employee subject to the covenant is laid off.[92]

Prior Breach

On breach of a material provision of an agreement, the non-breaching party is allowed to ignore those contractual obligations placed on it.[93] A total failure of consideration (a material breach) must exist for this defense to arise.[94] Whether a covenant not to compete has been materially breached is a factual, not a legal issue.[95]

***12 Focused Solicitation Restrictions**

Most covenants not to compete attempt to completely bar one party from competing with the party protected by the covenant in a given territory for a specific time. Other restrictions, which do not rise to the level of full prohibitions to competition, occur as well. The three most prevalent of these are (1) covenants that restrict the right of an employee to perform services for specified post-termination employers or in a given industry only, (2) provisions that bar post-termination solicitation of current customers of the employer, and (3) agreements that prohibit an employee from soliciting co-employees after the termination of his or her employment.

In *Management Recruiters*,[96] a former account executive of an employment recruiting agency went into competition with the agency. In the process of competing, he made placements of nine candidates who had been clients of the agency and with whom he had been in contact during his employment with the agency. The agreement between the agency and the account executive included a number of restrictions that generally prohibited the account executive from competing. In addition, a specific provision prohibited the account executive for a period of one year after termination from contacting any candidate with whom he had come in contact during the final year of his employment.

The trial court found the general noncompetition provisions to be void because the account executive was not a manager or executive as defined under CRS § 8-2-113(2)(d).[97] It enforced the narrow non-contact provision, however, finding that the identity, needs, and qualifications of the candidates were trade secrets, thus validating such provision under the trade secrets exception set forth in CRS § 8-2-113 (2)(b). The Court of Appeals affirmed.

Thus, pursuant to *Management Recruiters*, a non-solicitation covenant is enforceable, at least if it protects a trade secret. In addition, because the basis of the court's conclusion that the non-solicitation agreement was enforceable was the finding of an exception to the rule of prohibition in CRS § 8-2-113(2), it is likely that non-solicitation provisions will be enforced in the event an exception is found under subsections (2)(a) or (b) as well. The bottom line appears to be that non-solicitation agreements will be enforced in an identical fashion as full-blown covenants not to compete. In other words, if an exception is found to support the provision under subsections (2)(a), (b), or (d), the non-solicitation covenant will be found valid.

The Court of Appeals did note that the covenant as written in *Management Recruiters* barred the defendant from "'contacting *any* candidate' with whom he had contact or *access* to during the final 12 months in Recruiters' employ" (*emphasis in original*).[98] However, the court found that the trial court was correct in narrowly enforcing the non-solicitation provision to cover only those candidates with whom the defendant in fact had been in contact during his final year of employment, finding that the information represented by these persons constituted the only real trade secrets at issue.[99]

Likewise, it is not unusual to encounter a contractual provision that prohibits employees from soliciting co-employees after their termination. Such provisions will be enforced in much the same manner as full-blown covenants not to compete. In *Atmel Corp.*,[100] the Court of Appeals addressed the enforceability of such provisions. There, the individual defendants, who were originally employed by Atmel under agreements that barred them from soliciting co-employees on termination, were accused of raiding Atmel's employees after they left to become employed by Vitesse. An injunction was entered prohibiting the individual defendants from any involvement in Vitesse's recruiting efforts of Atmel employees.

The Court of Appeals found such a restriction to be unduly broad. Instead, the court agreed with the defendants' contention

that the provision at issue prohibited the individual defendants from "directly or indirectly ... solicit [[ing], recruit[ing] or attempt[ing] to persuade any person to terminate such person's employment with (Atmel)."[101] The court specifically found that the "custom in the semiconductor industry is to interpret non-solicitation covenants to prohibit only solicitation."[102] Next, the court referred to the recitals and subject titles in the parties' agreement to find that the agreement as drafted only restricted the employees from involvement in solicitation of co-employees, not any involvement whatsoever in a future employer's recruitment efforts.[103]

The inclusion of language restricting the individual defendants from "directly or indirectly" being involved in solicitation was not deemed sufficient by the court to lend a broad application to the restriction.[104] Lastly, the court found that a liberal construction of the non-solicitation provision to preclude any activity in regard to recruitment would be violative of CRS § 8-2-113.[105] Thus, the court interpreted the enforceability of non-solicitation agreements under the same analysis it applies to straight non-compete provisions.[106]

Remedies for Breach

No language covering remedies for breach of a covenant not to compete exists in CRS § 8-2-113(2). It thus appears that normal damages principles apply to such agreements. Under normal contract damages rules, the injured party may recover those lost net profits that are the proximate result of the actionable conduct upon which judgment is entered.[107] The normal lost profits measure of damages, applied to the breach of a non-competition covenant, should allow for recovery of all profits lost due to business usurped by the ex-employee.

It is uncertain what proof will establish damages for breach of a covenant not to compete. Under normal lost profits damages rules, the fact of damage must be established with a reasonable degree of certainty. Once the fact of damage is proved, however, the amount of damages need not be established with certainty. An approximation derived from a reasonable method is sufficient,[108] provided the plaintiff has offered the best evidence available. The key is proving a course of business activity through business records.[109] It would seem that income earned by the party in breach of the covenant from those accounts serviced by the plaintiff prior to breach (with a reasonable accounting for normal expenses to be incurred in the event the plaintiff still serviced such business) would reasonably approximate the plaintiff's lost profits.

Income earned by the ex-employee by servicing accounts that were not customers of the employer prior to termination may not be a loss directly attributable to the ex-employee's activity. While the employee would be in violation of most covenants not to compete by conducting business with anyone within the restricted territory, it may be difficult for the employer to establish that an account with which it was not engaged in business should be included in its lost profits formulation.

A covenant not to compete restricts competition; it does not require an employee to remain employed by the employer. Accordingly, it is by no means clear that an employer could claim all income of the ex-employee as the basis for the income side of a damages formulation. Injunctive relief is available in addition to money damages ***14** for breach of a covenant not to compete.[110] Injunction relief, however, is not available beyond the covenant's stated time.[111]

New Employer Liability

Colorado recognizes the claims of intentional interference with contractual relations.[112] and intentional interference with prospective business advantage.[113] For a claim of interference with contract to arise, the defendant must either know or have reason to know of a contract between parties other than itself.[114] For a claim of interference with prospective business advantage, the defendant must be shown to have intentionally and improperly interfered with the formation of a contract.[115] For either claim, the defendant's conduct must be shown to be intentional and improper.[116] In determining whether interference is intentional and improper, courts are to consider the interferer's motivation, the nature of the interferer's conduct, the interest of the other with whom such conduct interferes, the interest sought to be advanced by the interferer, and the proximity or remoteness of the interference to the plaintiff's harm.[117]

Interference with contract claims lies only against those who are not a party to the contract.[118] Supervisors, officers, and directors of an employer can be held personally liable for interference with the contract between the employer and employee.[119] Damages for interference with contract include the loss caused by the breach, including loss of profits or other

compensatory damages.[120] Interfering with a void contract does not constitute the basis for a claim of intentional interference. Thus, a third party who induces the breach of a covenant not to compete that is determined to be void under CRS § 8-2-113(2) has no liability to the party seeking such covenant's enforcement.[121]

A qualified privilege of competition exists as to intentional interference claims under *Restatement (Second) of Torts*, § 768(1):

> One who intentionally causes a third person not to enter into a prospective contractual relation with another who is his competitor ... does not interfere improperly with the other's relation if:
>
> (a) the relation concerns a matter involved in the competition between the actor and the other and
>
> (b) the actor does not employ wrongful means and
>
> (c) his action does not create or continue an unlawful restraint of trade and
>
> (d) his purpose is at least in part to advance his interest in competing with the other.

In *Occusafe, Inc.*,[122] the competition privilege defeated a claim of intentional interference with prospective business advantage as to the recruitment and hiring of certain industrial hygienists who were parties to covenants not to compete with their old employer. The old employer had acted as a consultant to the defendant, which elected to hire the industrial hygienists directly and terminate the consulting agreement.

Finding that both companies were "competitors" as buyers of the services of industrial hygienists, the Tenth Circuit Court of Appeals construed *Restatement of Torts* § 768(1) as extending the competitor privilege to those situations where the parties compete in any way. The Tenth Circuit further concluded that "wrongful means" were not utilized in soliciting the hygienists under *Restatement* § 768(1), noting that conduct "such as physical violence, fraud, civil suits, and criminal prosecutions" is required for wrongful means to occur.[123]

Allowing an employee to use general knowledge the employee learned while employed by an ex-employer is not actionable.[124] However, there may be liability for allowing an employee to use information the new employer knows or has reason to know constitutes confidential information of an ex-employer.[125]

Choice of Law Issues

Some covenants not to compete have restricted geographic areas that go beyond the borders of a given state. Others feature choice of law clauses that select the law of one state to apply to all conduct arising under the agreement, even that conduct arising in a state different from that whose law is chosen. In addition, attempts are commonly made to enforce covenants not to compete entered in one state in a sister state. These situations may cause a choice of law issue to arise in the event of litigation.

Colorado uses the "most significant relations" test to determine choice of law issues.[126] For contract matters, this test looks to five factors: place of contracting; place of negotiation; place of performance; location of the subject matter; and the domicile, residence, place of incorporation, or place of doing business of the parties.[127] In addition, courts making a choice of law determination are to look to the policies of each of the interested states to determine if such policies strongly militate for or

against the adoption of the forum jurisdiction's own laws.[128]

The Tenth Circuit Court of Appeals, in *Dresser Industries, Inc. v. Sandvick*,[129] found the Colorado General Assembly's passage of CRS § 8-2-113(2) to be a manifestation of a strong public policy against those non-compete provisions found void under subsection (2).[130] As a result, the *Dresser* court applied Colorado law to a covenant that was signed by an employee who lived in Colorado at the time of execution, even though the employer was a Delaware corporation based in Texas, and the employee was transferred to North Dakota by the employer shortly after the non-compete was executed and performed his work duties there.

Finding that the most important factor in the analysis presented was represented by the policies of the various states, the court examined the law of each of the states with an interest in the controversy. The court noted that North Dakota, Montana, and Colorado had statutory prohibitions against covenants not to compete, while Texas did not (the plaintiffs argued that Texas law should apply). Stating that the legislatures of the first three states all invalidated covenants not to compete of the nature sought to be enforced in the case before it, the court found such legislative enactments to be stronger statements of policy against non-compete covenants than Texas's non-statutory policy in favor of enforcement of certain covenants.[131]

Finally, the *Dresser* court examined "the strength of the policy of the forum state, Colorado."[132] In so doing, the court noted that "(t)he substantive law of another jurisdiction should not apply if application of that law would violate a fundamental policy of the forum."[133] The court recognized that the trial court found Colorado's passage of CRS § 8-2-113(2) to be reflective of a strong policy against covenants not to compete.[134] Thus, the Tenth Circuit held that the trial court was correct in applying the law of the states other than Texas because the concept of enforcing the covenants was repugnant to the policies of Colorado, the forum state.[135]

No choice of law clause existed in the contracts at issue in *Dresser*.[136] While there is no Colorado case regarding the enforceability of a choice of law clause in a non-compete agreement, there is reason to suspect that Colorado courts will ignore such provisions, provided the connection is strong between Colorado and either the contracting parties or the subject matter ***15** of the contract. Generally, if a choice of law clause does exist in an agreement, the law of the chosen state will apply unless (1) the chosen state has no substantial relationship with the parties or the transaction or (2) application of the chosen state's law will be contrary to the fundamental policy of a state that has a greater material interest in the issue than the chosen state (and such state would be the state with the applicable law in the absence of the choice of law clause).[137]

In *Curtis 1000, Inc. v. Youngblade*,[138] the U.S. District Court for the Northern District of Iowa refused to apply a choice of law clause contained in a covenant not to compete that chose the law of Delaware, a state that would enforce the covenant at issue, whereas Iowa law would not (on common law, not statutory grounds). The plaintiff was a Delaware corporation with its principal place of business in Georgia. The defendant ex-employee lived and worked primarily in Iowa. Despite the choice of law clause, the court applied Iowa law, finding: (1) Delaware had no substantial relationship with the contract or the defendant's employment thereunder; (2) Iowa law would apply in the absence of a choice of law clause; and (3) Delaware law was repugnant to Iowa law, which barred the type of covenant sought to be enforced.[139]

DeSantis v. Wackenhut Corp.[140] features a like analysis. In *DeSantis*, the choice of law clause called for application of Florida law to a Texas resident who had signed a covenant not to compete in Texas with a Florida employer. The covenant barred the ex-employee from post-termination competition in Texas. The court found that, while Florida had an interest in the uniform application of a contractual provision for a nationwide business, Texas had an overriding interest in competition within Texas by a Texas resident who had formed his own Texas company. Finding the covenant to be unenforceable under Texas case law (no statutory prohibition existing), the court refused to enforce the choice of law clause and applied Texas law instead.[141] It should be noted that neither Iowa nor Texas has statutory prohibitions against non-compete agreements. CRS § 8-2-113(2) does. This fact, combined with the Tenth Circuit's refusal to apply the law of a state that would validate a covenant void under CRS § 8-2-113(2), may lead Colorado courts to ignore choice of law clauses that select the law of a state that allows such covenants.

PRE-TERMINATION COMPETITION: DUTY OF LOYALTY

An employee may not compete with his or her employer during the term of employment.[142] This rule has its genesis in the law of agency, which requires that an agent act with utmost good faith and loyalty to the principal.[143] Such rule requires the agent

to act solely for the benefit of the principal in all matters.[144] The scope of the duty is accordingly broad.

The seminal employee duty of loyalty case in Colorado is *Jet Courier Service, Inc. v. Mulei*.[145] There, the Colorado Supreme Court found that the pre-termination efforts to compete by the general manager of a Denver-based air courier service constituted a breach of the duty of loyalty. Included in the defendant's pre-termination conduct was the organization of a competing air courier, the solicitation of the plaintiff's customers, and the orchestration of a mass resignation of plaintiff's employees.

Those in a Position of Trust or Confidence

In *Mulei*, the Court found that the duty of loyalty applied because the defendant occupied a position of trust and confidence.[146] Nevertheless, in discussing whether all employees were burdened with a duty of loyalty, the Court stated the following:

> ... [W]e need not attempt to delineate the precise scope of an employee's duty of loyalty as applied to all factual situations .... Accordingly, we choose to describe the duty at issue here simply as a "duty of loyalty" arising out of the employer-employee relationship. Additionally, we need not determine whether the duty of loyalty discussed in this opinion applies in all its rigor to every employment relationship regardless of the nature of the work performed by the employee .... In any event, we need not determine the full scope of applicability of the duty of loyalty here since this duty is clearly applicable to Mulei because his position was one of sufficient authority that the principal/agent analogy is apt beyond question.[147]

Thus, the Court did not reach the issue of which employees would be included within the duty, but only noted that all employees in a position of trust or confidence, such as officers, are included.[148] For non-officers, inclusion likely rests on the relative degree of trust in which such employees' position places them.[149]

Duty Ceases at Termination

As stated above, the duty of loyalty is rooted in the law of agency.[150] Under general agency principles, a duty of loyalty exists on the part of independent contractor agents who are in a fiduciary or quasi-fiduciary capacity with their principal.[151] Although some fiduciary responsibilities, such as the duty to retain the confidence of proprietary information shared by the principal during the agency, may last beyond termination of the project for which the agent was retained, the duty of loyally ceases on completion of the project.[152] For employees, the duty of loyalty ceases on termination of employment.[153] Prior to termination, an employee may undertake preparatory steps toward competition, such as retaining legal and accounting assistance, obtaining financing, renting facilities, and purchasing equipment, without violating the duty of loyalty. The actual conducting of business, however, is not allowed until after termination.[154]

Application to Employees' Off-Work Activities

In *Marsh v. Delta Airlines, Inc.*,[155] a baggage handler was terminated for mailing ***16** a letter critical of airline management to a newspaper. The baggage handler sued for wrongful discharge. The court entered summary judgment, dismissing the claim on the grounds that the employee breached a duty of loyalty he owed to the airline, which was found to apply to the employee's off-hours activity related to his job.

The court found that, as long as an employee engages in lawful activities off the employer's premises during nonworking hours, the employer cannot fire the employee, unless that activity

> [r]elates to a bona fide occupational requirement or is reasonably and rationally related to the employment activities and responsibilities of a particular employee or a particular group of employees ...; or ... [i]s necessary to avoid a conflict of interest with any responsibilities to the employer or the appearance of such a conflict of interest.[156]

The criticism in the employee's letter was found to be reasonably related to his employment duties, however, and was held to constitute a breach of the duty of loyalty he owed to the employer-airline.[157]

Remedies

Normal legal and equitable remedies (damages and injunctive relief) appear to be available for instances of breach of the duty of loyalty.[158] In addition, the employer may seek disgorgement of all compensation paid to the employee during the period of disloyalty.[159]

DRAFTING ISSUES REGARDING COVENANTS NOT TO COMPETE

The law governing covenants not to compete in Colorado is fairly voluminous and well-developed. Clearly, the impact of CRS § 8-2-113(2) renders drafting non-competition agreements a challenging task. Counsel should pay special attention to the rule of prohibition in the statute. Moreover, if a viable covenant is to be created, counsel will be required to find and develop an exception to such rule of prohibition.

Determining the Exemption

Before drafting a non-compete agreement, practitioners first need to determine whether an exempt category exists under the statute. This will not be difficult in sale of business situations because CRS § 8-2-113(2)(a) applies to all bulk sales of stock or assets. In the event a partial ownership interest is in play, such as when a buy-sell agreement is being prepared between co-owners, counsel should advise the parties to agree expressly that it is their intent that the sale of business exception apply.[160] When drafting a covenant relating to a bonus of stock or other ownership interest, it is advisable to state that the sale of business exception is deemed applicable as well, even though it is uncertain whether the courts will accept such a provision as creating a *bona fide* exemption under subsection (2)(a).

Finding an exempt category is more problematic in an employment context. If the employee truly has executive or management responsibilities, the chance of court enforcement of a covenant is likely. When employees who are marginally involved in management are the subject of the covenant, however, it may be prudent for employers' counsel to refer specifically to the exception under CRS § 8-2-112(2)(d) as being deemed applicable by both parties. Because Colorado cases direct the manager/executive analysis to whether an employee is "in charge," it may be wise to afford the employee some real management duties to gain an increased chance of validity. If this is done, the agreement should not only specifically refer to such duties but should also state that both parties agree such duties are those of a true manager.

When the employee is not a manager or executive (for example, a salesperson), establishing an enforceable situation is difficult. One situation that may provide some protection for an employer is where a true trade secret exists.[161] Under CRS § 8-2-113 (2)(b), the parties may agree to certain nondisclosure provisions as part of the contractual package defining their employment relationship. It is not clear, however, whether a stated interest in protecting trade secrets is enough to support a complete bar covenant not to compete. In *Colorado Accounting Machines, Inc. v. Mergenthaler*,[162] the Court of Appeals stated that trade secrecy may not be used as the basis for a full prohibitive covenant when the remedy of non-disclosure will adequately protect the proprietary nature of the information. The Court of Appeals did nonetheless permit an injunction barring such competition as an appropriate remedy for a trade-secret-based covenant in *McGuay*.[163]

For most licensed professionals, at least those engaged in "legal, engineering, scientific and medical" occupations,[164] covenants not to compete will be enforceable under subsection (2)(d). When a covenant is with a physician, however, close attention must be paid to CRS § 8-2-113(3) and the *Wojtowicz* decision.[165] Extra care also must be taken to craft remedies that relate to the net profit interest of an existing medical practice under *Wojtowicz*. Provisions to pay liquidated damages under subsection (3) are unenforceable if they rely solely on arbitrary amounts or if they deal primarily with income generated by the terminating physician.[166]

Colo.RPC 5.6 provides that competition provisions between attorneys must arise from a sale of goodwill of an existing practice to pass ethical muster. Therefore, in drafting a covenant not to compete between lawyers, the drafting attorneys should take special care to ensure that such covenant arises from a sale of an existing practice where goodwill is among the

assets sold. Further, the language of the agreement itself should reflect that such a sale is the setting from which the covenant arises.

Covenants entered into with junior professional assistants likely will come within the exception provided in subsection (2)(d),[167] although it is by no means clear exactly who is included within such exception. Because of the uncertainty in regard to junior professional assistants' professional status, language should be included to the effect that such persons agree that they come within the "professional staff" portion of the (2)(d) exception,

Reasonable Language as to Time, Geography, and Scope

Once drafting attorneys have an acceptable degree of comfort that an exception under CRS § 8-2-113(2) is available, they must craft language that is likely to be found reasonable as to time, geography, and scope. Although no hard and fast rules exist as to reasonableness, guidance is provided by the cases cited above.[168] It is advisable to include language to the effect that both parties agree that the time and geographic limitations of the covenant are reasonable. The agreement also should have language directing a court to reform a covenant it finds unreasonable to a level that it does find reasonable.

Moreover, attorneys representing parties to be protected by a covenant should use language that prohibits a very broad array of direct or indirect competitive activity, as courts probably will enforce a broadly written covenant to the extent possible under CRS § 8-2-113(2) and the rule of reasonableness.[169] Provisions for cumulative remedies also are a wise addition, as they appear to be available under *Moore*.[170]

***18 Consideration Issues in Drafting Non-competes**

Assuming that a covenant will pass muster under the exceptions to CRS § 8-2-113(2) and that the covenant is reasonable, employers' counsel should ensure the presence of consideration. In Colorado, it is questionable whether the mere continuation of an existing employment relationship will be sufficient on its own as consideration to support a covenant not to compete.[171] Therefore, employers' attorneys are advised to draft covenants in a way that couples execution of the covenant to a promotion, increase in pay, or bonus (either of stock or cash). If the covenant is joined to such an event, the event should be expressly referred to in the covenant as part of the consideration being afforded the employee for the restrictions contained in the covenant. Also, a statement in the covenant to the effect that duress is not present is advisable.

Because covenants not to compete normally will expire in the event the business to be protected thereby ceases to exist,[172] it is wise for employers' counsel to include language to the effect that the covenant may be assigned in the event the business is acquired during the covenant period. If this language is included, specific terms should be added detailing that the employee grants his or her consent to such an assignment—this should aid in the covenant's continued validity.[173]

Advising Employees

Non-competes are almost always drafted on behalf of the party seeking to be protected. Therefore, most of the comments in this section have related to drafting issues from the perspective of that party. Just as employers' attorneys must focus on obtaining an exception to CRS § 8-2-113(2)'s rule of invalidity, however, counsel advising parties who are to be burdened by a non-compete should be aware of whether a situation exists that will give rise to a valid exception and, thus, an effective agreement. Often, the client will have no choice but to sign an agreement with anti-competitive language, so attorneys representing such persons should be especially attuned to whether an enforceable agreement is even possible.

Where the agreement is likely to be void under CRS § 8-2-112(2), the question becomes whether the defective nature of the agreement should be raised at the outset so the employer understands that the covenant is likely to be invalid or if a "don't ask, don't tell" approach should be taken.

Because the client's only effective alternative to execution of the covenant may be termination, advising the client about the potential invalidity of the agreement and having the client execute the covenant may be the best strategy. Even if the client executes the covenant, it may be challenged later, in the event the employer seeks enforcement. In addition, employees'

counsel may attempt to suggest language that creates a covenant with a narrow scope; that is, providing that only certain limited types of post-termination activity are prohibited.

LITIGATION ISSUES REGARDING COVENANTS NOT TO COMPETE

Injunction Issues

Part I of this article discussed the unique challenges presented by litigating trade secrecy matters.[174] Many of those issues also exist as to covenants not to compete. As with trade secrecy provisions, attempts to enforce non-compete agreements often focus on gaining preliminary injunctive relief.[175] Also, as with trade secrecy, the party who prevails at a preliminary injunction hearing on a covenant not to compete often enjoys the upper hand. If the employer gains an injunction, the ex-employee is typically removed from any effective competition through trial. On the other hand, if the employee is successful in fending off the injunction, he or she will be able to engage in the business sought to be protected by the covenant pending trial.

Attorneys defending employees in injunction hearings should focus on establishing invalidity of the covenant through lack of an exception under CRS § 8-2-113(2) or using arguments that the covenant is unreasonable, lacks consideration, or is the product of duress. Defense counsel should also devote attention to having the court set bond at a relatively high amount. Arguments for this are based on the fact that if the employee is barred from competition through trial, he or she stands to suffer substantial harm. In addition, if bond is set at a relatively high amount, some plaintiffs may lose their enthusiasm for an injunction, considering the cost. Pursuant to C.R.C.P. 65, bond is to be set at an amount sufficient to secure the enjoined party from any harm or damage that may be reasonably anticipated in the event the injunction is later found to have been improvidently entered.[176]

It is a fairly typical employer drafting practice in regard to non-compete agreements to fix the bond or other security for the issuance of a preliminary injunction at a minimal amount. However, this practice has likely been dealt a serious blow in the recent *Atmel* opinion.[177] There, the security ordered by the trial court for the preliminary injunction it entered was set at $5,000. The trial court found this an adequate amount to cover the expenses that Vitesse, the corporate defendant, would be forced to incur for a number of its human resources personnel to travel to Colorado Springs. These employees were to replace the individual defendants for ten days' activity in its hiring process, the individual defendants having been enjoined through trial from assisting in Vitesse's hiring activities.[178]

The Court of Appeals held such determination to be error, emphasizing that the analysis on setting the amount of security for a preliminary injunction is to focus on the injury the defendants are likely to incur in the event they are wrongfully enjoined. The injunction barring the individual defendants from participating in Vitesse's hiring activities was for a full year. The Court of Appeals noted that C.R.C.P. 65(c) limits trial courts' discretion as to the security to be imposed for a preliminary injunction to the amount that "bear[s] a reasonable relationship to the potential costs and losses occasioned by [the] preliminary injunction."[179] Therefore, the court found the $5,000 amount inadequate to protect the corporate defendants for the costs they would incur in replacing the individual defendants for the full-year term of the injunction.[180]

In *Atmel*, the agreement itself did not call for the $5,000 amount of security. However, the case clearly directs trial courts to determine independently whether an amount of security is sufficient to protect the enjoined defendants from losses they will incur because of the imposition of the injunction. Thus, agreements calling for a low amount of security may be deemed inadequate and ignored in favor of such an independent analysis.

Discovery

As with trade secrecy litigation, discovery by parties seeking enforcement of a covenant not to compete should focus on gaining access to documents that will provide a good illustration of the other party's activities. These include bank statements, credit card receipts, phone bills, fax transmittals, written correspondence, and advertising copy. Because breach of the duty of loyalty also is actionable (and features ***19** the additional remedy of compensation disgorgement),[181] employers should gain access to documents that reflect when the ex-employee began his or her competitive activities. Evidence of an

activity that itself is not in violation of the duty of loyalty (opening bank accounts; retaining legal and accounting assistance; leasing space; purchasing equipment, furniture, and supplies)[182] may nonetheless be illustrative of when activity began that is in violation of the duty of loyalty.

One of the most likely areas for an ex-employee to find customers is the ex-employer's customer base. Therefore, counsel involved in an attempt to enforce a covenant not to compete against a competing ex-employee may be required to call customers as witnesses. This should be approached with caution, unless the customer's loyalty to the client is unquestioned. Virtually everyone is adverse to being involved in litigation, and testifying is usually an unpleasant experience. Being a witness can not only cause emotional turmoil, but may require customers to devote attention to matters not directly related to their business. A common scenario when customers are thrown into the fray over competition is for them to give their business to a third party, instead of to either litigant. In such instances, the potential for "economic murder-suicide" is very real.

When making decisions as to persons to involve in a case when breach of a covenant not to compete is at the core, counsel for both the employee and employer should be especially careful. The danger of alienating customers should be weighed against a customer's value as a witness. If customers have been solicited by the ex-employee, their testimony can be very powerful for employers. A good employer strategy is to use customers to establish competition, but to be selective as to how many customers to use in this role. Further, employers should keep the scope of the customers' testimony narrowly focused on the facts at hand (for example, solicitation) so that any inconvenience may be minimized.

CONCLUSION

Trade secrecy and competition covenants present many challenges for Colorado attorneys. Agreements attempting to protect confidential information and restrict post-termination competition have become increasingly common over the past ten years, resulting in a rapidly growing volume of litigation and many appellate decisions. This growth is unlikely to abate. Attorneys should become familiar with the statutory provisions discussed in this two-part article. Those practicing in this area need to make special efforts to stay abreast of new case law developments in order to represent their clients as effectively as possible.

Footnotes

a1 *John F. Reha, Littleton, is a partner in the firm of Arckey & Reha, L.L.C.—(303) 798-8546. Reha has a general business practice with an emphasis on intangible asset protection issues, including drafting and litigation issues related to trade secrecy and competition restrictions. The author would like to thank his partner, Tom Arckey, for his invaluable assistance with this article and "for keeping the (billable) home fires burning" while the author was busy writing this arcticle.*

1 Reha, "The Law of Trade Secrecy and Covenants Not to Compete in Colorado—Part I," 30 *The Colorado Lawyer* 7 (April 2001).

2 CRS § 8-2-113(2). Some other states also have statutory prohibitions against certain non-compete covenants. *See, e.g., Dresser Industries, Inc. v. Sandvick*, 732 F.2d 783, 786 (10th Cir. 1984) (discussing N.D.Cent. Code § 9-08-06 and Mont. Code Ann. § 28-2-703), and *Atmel Corp. v. Vitesse Semiconductor Corp.*, 30 Colo.Law. 141, 142 (April 2001) (App. No. 98CA0586, *annc'd* 2/15/01) [discussing Cal. Bus. & Prof. Code § 16600 (2000)].

3 *DBA Enterprises, Inc. v. Findlay*, 923 P.2d 298 (Colo.App. 1996).

4 *National Propane Corp. v. Miller*, 29 Colo. Law. 159, 161 (Aug. 2000) (App. No. 99CA0149, *annc'd* 6/22/00). *See also In re Marriage of Graff*, 902 P.2d 402 (Colo.App. 1994).

5 *National Propane Corp., supra*, note 4 at 161. *See also In re Marriage of Nichols*, 606 P.2d 1314 (Colo.App. 1979).

[6] *National Propane Corp.*, *supra*, note 4 at 161. *See also* *Gibson v. Eberle*, 762 P.2d 777 (Colo.App. 1988).

[7] *Network Telecommunications, Inc. v. Boor-Crepeau*, 790 P.2d 901 (Colo.App. 1990).

[8] *DBA Enterprises, Inc.*, *supra*, note 3; *National Propane Corp.*, *supra*, note 4.

[9] 577 P.2d 302 (Colo.App. 1977), *cert. denied*, 1978.

[10] 834 P.2d 270 (Colo.App. 1992).

[11] *Id.* at 272.

[12] *Supra*, note 1 at 15.

[13] *See DBA Enterprises, Inc.*, *supra*, note 3; *Gibson*, *supra*, note 6; *National Propane Corp.*, *supra*, note 4.

[14] 651 P.2d 464 (Colo.App. 1982).

[15] *Supra*, note 9.

[16] *Id.* at 304-05.

[17] *Supra*, note 14.

[18] *Supra*, note 10.

[19] *Id.* at 273.

[20] *National Propane Corp.*, *supra*, note 4 at 161.

[21] *See* note 1, *supra*, at 15.

[22] *See Dresser Industries*, *supra*, note 2.

[23] *Id.* at 788.

[24] *Porter Industries, Inc. v. Higgins*, 680 P.2d 1339, 1342 (Colo.App. 1984).

[25] *Id.*

[26] *Alexander & Alexander, Inc. v. Hall and Co.*, Civ. Act. No. 88-A-1621 (D.Colo. 1990).

[27] *Supra*, note 10.

[28] *Supra*, note 9.

[29] *Supra*, note 2.

[30] *Id.* at 143.

[31] *Id.*

[32] 762 P.2d 763 (Colo.App. 1988).

[33] *Id.* at 765.

[34] *Moore*, *supra*, note 14.

[35] *Id.* at 465.

[36] 54 F.3d 618 (10th Cir. 1995).

[37] 747 P.2d 15 (Colo.App. 1987), *cert, denied*, 1987.

[38] *Supra*, note 14.

[39] CRS § 12-36-106(1)(d).

[40] 961 P.2d 520 (Colo.App. 1997), *cert. granted*, 1998.

[41] *Id.* at 522.

[42] *Id.* at 523.

[43] *Id.*

[44] *Id.*

[45] *Id.*

[46] *Management Recruiters*, *supra*, note 32 at 766.

[47] *Id.*

[48] *Supra*, note 40 at 522.

[49] *Moore*, *supra*, note 14.

[50] *Id.*

[51] *Supra*, note 32.

[52] *Id.* at 765.

[53] 797 P.2d 1303 (Colo.App. 1990).

[54] *Id.* at 1305.

[55] *Supra*, note 37.

[56] 937 P.2d 907 (Colo.App. 1997).

[57] *Id.*

[58] *Supra*, note 14 at 466.

[59] *Supra*, note 4 at 161.

[60] *Id.* at 162.

[61] *Id.*

[62] *Id.* at 161.

[63] *Management Recruiters*, *supra*, note 32 at 766.

[64] *National Graphics Co. v. Dilley*, 681 P.2d 546 (Colo.App. 1984).

[65] *Zeff, Farrington & Associates, Inc. v. Farrington*, 449 P.2d 813, 814 (Colo. 1969).

[66] *Knoebel Merchantile Co. v. Siders*, 439 P.2d 355, 358 (Colo. 1968).

[67] *See, e.g.*, *Fuller v. Brough*, 411 P.2d 18 (Colo. 1966); *Flower Haven, Inc. v. Palmer*, 502 P.2d 424 (Colo.App. 1972).

[68] *Knoebel Merchantile Co.*, *supra*, note 66 at 358.

[69] *Sprague's Aetna Trailer Sales, Inc. v. Hruz*, 474 P.2d 216 (Colo. 1970) (seventy-five miles and one year); *Zeff, Farrington & Assoc., supra*, note 65 (200 miles and three years); *Fuller v. Brough, supra*, note 67 (forty-five miles and five years); *Freudenthal v. Espey*, 102 P. 280 (Colo. 1909) (city limits and five years); *McGuay, supra*, note 56 (fifty miles and three years); *Taff v. Brayman*, 518 P.2d 298 (Colo.App. 1974) (sixty-five miles and two years); *Palmer, supra*, note 67 and *Gibson v. Angros*, 491 P.2d 87 (Colo.App. 1971) (Boulder County and five years); *Short v. Fahrney*, 502 P.2d 982 (Colo.App. 1972) (Denver metropolitan area and two years); *Wagner v. A&B Personnel Sysems, Ltd.*, 473 P.2d 179 (Colo.App. 1970) (fifty miles and one year); *Electrical Distributors, Inc. v. SFR, Inc.*, 166 F.3d 1074 (10th Cir. 1999) (state of Utah and seven years).

[70] *Charles Milne Assoc. v. Toponce*, 770 P.2d 1313 (Colo.App. 1988); *National Graphics Co., supra*, note 64.

[71] *National Graphics Co., supra*, note 64.

[72] 477 P.2d 489 (Colo.App. 1970).

[73] *Whittenberg v. Williams*, 135 P.2d 228 (Colo. 1943) (worldwide restriction reduced to section of Colorado); *Gulick, supra*, note 72 (restriction reduced from within thirty-five miles of any of plaintiff's offices to within ten miles of Denver).

[74] *National Graphics, supra*, note 64 at 547.

[75] *Taff, supra*, note 69 (trial court's modification of a two-year provision reduced to one year reversed when no finding of unreasonableness).

[76] *Parent v. Kopanos*, 368 P.2d 784, 787 (Colo. 1962).

[77] *Whittenberg, supra*, note 73 at 229; *Management Recruiters, supra*, note 32 at 766.

[78] *DeJean v. United Airlines, Inc.*, 839 P.2d 1153, 1160 (Colo.1992).

[79] *See Vail/Arrowhead, Inc. v. District Court*, 954 P.2d 608, 613 (Colo. 1998).

[80] *Pittman v. Larson Distributing Co.*, 724 P.2d 1379, 1384 (Colo.App. 1986).

[81] *Miller v. Davis' Estate*, 122 P. 793, 794 (Colo.1912); *DeJean, supra*, note 78 at 1160.

[82] *Freudenthal, supra*, note 69.

[83] *Richardson v. Jordan*, 95 Colo. 56, 32 P.2d 826, 827 (1934).

[84] *Id.; see also DeJean, supra*, note 78 at 1157.

[85] 464 A.2d 1104 (Md.App. 1983).

[86] *Richardson, supra*, note 83; *DeJean, supra*, note 78.

87 *Gibson, supra*, note 6. *See also National Propane Corp., supra*, note 4.

88 *Richardson, supra*, note 83; *DeJean, supra*, note 78.

89 *Gibson, supra*, note 6 at 779.

90 *Id.; see also National Propane Corp., supra*, note 4.

91 *Miller v. Kendall*, 541 P.2d 126, 127 (Colo. App. 1975), *cert. denied*, 1975; *Cantrell v. Lemons*, 200 P.2d 911 (Colo. 1948).

92 *Post v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 48 N.Y.2d 84 (1979); *In re UFG International, Inc.*, 225 B.R. 51 (S.D.N.Y. 1998).

93 *Converse v. Zinke*, 635 P.2d 882 (Colo. 1981).

94 *Id.* at 887.

95 *DBA Enterprises, Inc., supra*, note 3.

96 *Supra*, note 32.

97 *Id.* at 765.

98 *Id.*

99 *Id.*

100 *Supra*, note 2.

101 *Id.* at 142.

102 *Id.*

103 *Id.*

104 *Id.*

105 *Id.*

106 The court in *Atmel* found, in regard to the trade secrecy exception in CRS § 8-2-113 (2)(b), that no evidence was produced by Atmel to show its employee ranking system was a trade secret. Further, because information known to employees through means independent of knowledge imparted to them by the employer is not secret, the ex-employees' subjective opinions about ex-coworkers was determined not to be a trade secret. *Supra*, note 2 at 143. The *Atmel* decision was published after Part I of this

article was finalized.

107 *Lee v. Durango Music, Inc.*, 355 P.2d 1083 (Colo. 1960); *Graphic Directions, Inc. v. Bush*, 844 P.2d 1190 (Colo.App. 1992), *cert. granted*, 1993.

108 *Id.*

109 *Id.*

110 *Moore*, *supra*, note 14.

111 *Atmel*, *supra*, note 2 at 143-44.

112 *Trimble v. City and County of Denver*, 697 P.2d 716 (Colo. 1985).

113 *Occusafe, Inc.*, *supra*, note 36; *Memorial Gardens, Inc. v. Olympia Sales & Management Consultants, Inc.*, 690 P.2d 207 (Colo. 1984); *Dolton v. Capitol Fed. Sav. & Loan Ass'n*, 642 P.2d 21, 23 (Colo.App. 1981).

114 *Bithell v. Western Care Corp.*, 762 P.2d 708 (Colo.App. 1988).

115 *Occusafe, Inc.*, *supra*, note 36.

116 *Restatement (Second) of Torts*, § 767; *Amoco Oil Co. v. Ervin*, 908 P.2d 493 (Colo. 1995).

117 *Memorial Gardens, Inc.*, *supra*, note 113; *Cronk v. Intermountain Rural Elec. Ass'n*, 765 P.2d 619, 623 (Colo.App. 1988).

118 *Trimble*, *supra*, note 112 at 725-26.

119 *Cronk*, *supra*, note 117; *see also Dolton*, *supra*, note 113.

120 *Hein Centers v. San Francisco Real Estate Inv.*, 720 P.2d 975 (Colo.App. 1985).

121 *Colorado Accounting Machines v. Mergenthaler*, 609 P.2d 1125 (Colo.App. 1980) at 1126.

122 *Supra*, note 36.

123 *Id.* at 623.

124 *Rivendell Forest Products, Ltd. v. Georgia-Pacific Corp.*, 824 F.Supp. 961 (D.Colo. 1993).

125 *See, e.g.*, *Pepsico v. Redmond*, 54 F.3d 1262 (7th Cir. 1995) (head of sports beverage line of ex-employer's business enjoined from performing duties in running competing beverage business for new employer that would inevitably lead to use of ex-employer's confidential information).

126 *Dresser Industries, Inc., supra*, note 2 at 785.

127 *Id.*

128 *Id.* at 785-86; *Restatement (Second) of Conflicts of Laws* § 188.

129 *Supra*, note 2.

130 *Id.* at 787-88.

131 *Id.* at 786.

132 *Id.* at 787.

133 *Id.*

134 *Id.*

135 *Id.* at 788. The court did not specify if it was applying the law of Colorado or that of North Dakota and/or Montana, which would also invalidate the covenant. It did, however, refuse to apply Texas law.

136 *Id.* at 785.

137 *Schulke Radio Prod. v. Midwestern Broadcasting*, 453 N.E.2d 683 (Ohio St.3d 1983).

138 878 F.Supp. 1224 (N.D. Iowa 1995).

139 *Id.* at 1255-56.

140 793 S.W.2d 670 (Texas 1990).

141 *Id.* at 679.

142 *Jet Courier Service, Inc. v. Mulei*, 771 P.2d 486 (Colo. 1989); *Koontz v. Rosener*, 787 P.2d 192 (Colo.App. 1989).

143 *Hart v. Colorado Real Estate Comm'n*, 702 P.2d 763, 765 (Colo.App. 1985).

144 *Mulei, supra*, note 142; *Restatement (Second) of Agency*, § 387 (1957).

145 *Supra*, note 142.

146 *Id.* at 492.

147 *Id.* *Restatement (Second) of Agency*, § 387, comment b, states that an agent's "duties of loyalty to the interests of his principal are the same as those of a trustee to his beneficiaries." Furthermore, some cases from other jurisdictions, as well as the Court of Appeals' opinion in *Mulei*, characterize the duty of loyalty an employee owes to his or her employer as a "fiduciary" duty or a "fiduciary" duty of loyalty. *See, e.g.*, *AGA Aktiebolag v. ABA Optical Corp.*, 441 F.Supp. 747, 754 (E.D.N.Y.1977); *Maryland Metals, Inc. v. Metzner*, 382 A.2d 564, 569 (Md. 1978).

148 *Mulei*, *supra*, note 142 at 492. *See also* *Michaelson v. Michaelson*, 939 P.2d 835 (Colo. 1997).

149 *See* *Lacy v. Rotating Productions Systems, Inc.*, 961 P.2d 1144 (Colo.App. 1998); *c.f.* *Hewett v. Samsonite Corp.* 507 P.2d 1119 (Colo. 1973) (shop foreman did not have same duty of loyalty to corporation to assign patent rights despite written patent assignment agreement).

150 *See Koontz*, *supra*, note 142; *Hart*, *supra*, note 143.

151 *Id.*; *Boettcher DTC Bldg. Joint Venture v. Falcon Ventures*, 762 P.2d 788, 790 (Colo.App. 1988).

152 *Boettcher DTC Bldg. Joint Venture*, *supra*, note 151.

153 *Graphic Directions, Inc.*, *supra*, note 107.

154 *Id.; Mulei*, *supra*, note 142.

155 952 F.Supp. 1458 (D.Colo. 1997).

156 *Id.* at 1461; CRS § 24-34-402.5(1)(a).

157 *Marsh*, *supra*, note 155 at 1463.

158 *See Mulei*, *supra*, note 142.

159 *Id.* at 499.

160 *See Moore*, *supra*, note 14 at 465.

161 *Supra*, note 1 at 15-16.

162 *Supra*, note 121.

163 *Supra*, note 56. For an in-depth discussion of the trade secrets exception of CRS § 8-2-113(2)(b), *see* Part I of this article, *supra*, note 1 at 15-16.

164 *Moore*, *supra*, note 14 at 465.

165 *Supra*, note 40.

166 *Id.*

167 *See Moore, supra*, note 14 at 465.

168 *See, e.g.*, cases cited at notes 67-69, *supra*.

169 *National Propane Corp., supra*, note 4.

170 *Supra*, note 14.

171 *See, e.g., DeJean, supra*, note 78.

172 *National Propane Corp., supra*, note 4; *Gibson, supra*, note 6.

173 *Miller, supra*, note 91; *Cantrell, supra*, note 91.

174 *Supra*, note 1 at 17.

175 *Id.*

176 *Apache Village, Inc. v. Coleman Co.*, 776 P.2d 1154 (Colo.App. 1989).

177 *Atmel, supra*, note 2 at 144.

178 *Id.* at 143.

179 *Id.* at 144.

180 *Id.*

181 *Mulei, supra*, note 142.

182 *Id.*

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