

## Article

# The Law of Trade Secrecy and Covenants Not to Compete in Colorado—Part II

by John F. Reha

In Part I of this article, which appeared in the April 2001 issue,<sup>1</sup> 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.<sup>2</sup> 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.<sup>3</sup> 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."<sup>4</sup> Goodwill is "the expectation of continued and repeated public patronage."<sup>5</sup> 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.<sup>6</sup>

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,<sup>7</sup>

but are also common in sale of business transactions.<sup>8</sup> On occasion, they are encountered in other contexts as well. For example, in *Harrison v. Albright*,<sup>9</sup> a covenant not to compete was included as part of the collateral securing a business loan. In *Marriage of Fischer*,<sup>10</sup> 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*.<sup>11</sup> 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



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of subsection (2)(b) was discussed in Part I of this article.<sup>12</sup>

### **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.<sup>13</sup> 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*,<sup>14</sup> 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*,<sup>15</sup> 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.<sup>16</sup>

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*,<sup>17</sup> 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*,<sup>18</sup> 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)."<sup>19</sup> 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.<sup>20</sup>

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

This exception was discussed in detail in Part I of this article.<sup>21</sup>

### **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.<sup>22</sup> Recoupment of such expenses will be allowed, however, only where an agreement expressly providing for such recoupment exists between the employer and employee.<sup>23</sup>

### **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.<sup>24</sup> 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.<sup>25</sup> 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."<sup>26</sup>

Cases making determinations as to inclusion of an employee within the management, executive, and professional exception include *Marriage of Fischer*,<sup>27</sup> where the husband/business partner was "in charge of" a photo finishing business, and *Albright*,<sup>28</sup> 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.*,<sup>29</sup> 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,"<sup>30</sup> the court found that the employee in question did not supervise any other employees and, in fact, had three levels of management above him.<sup>31</sup> Moreover, in *Management Recruiters of Boulder, Inc. v. Miller*,<sup>32</sup> 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.<sup>33</sup>

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."<sup>34</sup> 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.<sup>35</sup> Thus, nurses and therapists probably fall within the exception. In *Ocusafe, Inc. v. EG&G Rocky Flats, Inc.*,<sup>36</sup> 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*,<sup>37</sup> 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.<sup>38</sup> In *Moore*, the defendant-physician was prohibited under sub-

section (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).<sup>39</sup>

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.*,<sup>40</sup> 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.<sup>41</sup> 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."<sup>42</sup>

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.<sup>43</sup> 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.<sup>44</sup> The court determined that the corporation had the burden of proving the validity of both damages provisions.<sup>45</sup>

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.<sup>46</sup> 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.<sup>47</sup>

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."<sup>48</sup> 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,"<sup>49</sup> 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,<sup>50</sup> 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.*,<sup>51</sup> 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

or is self-employed.<sup>52</sup> 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*,<sup>53</sup> the court stated that the trial court did not err in invalidating the non-competition covenants in the parties' contract.<sup>54</sup> 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*,<sup>55</sup> 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*,<sup>56</sup> 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 non-competition 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.<sup>57</sup>

### 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 defen-

dant'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.<sup>58</sup> 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*,<sup>59</sup> 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.<sup>60</sup>

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*).<sup>61</sup> The court did specify that

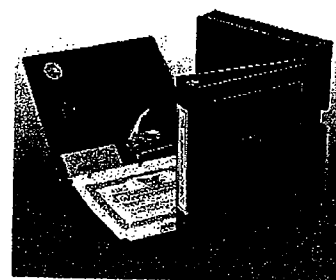
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