Will Your Non-Competition Provisions Hold Up Given the Recent Developments in Nevada Law?

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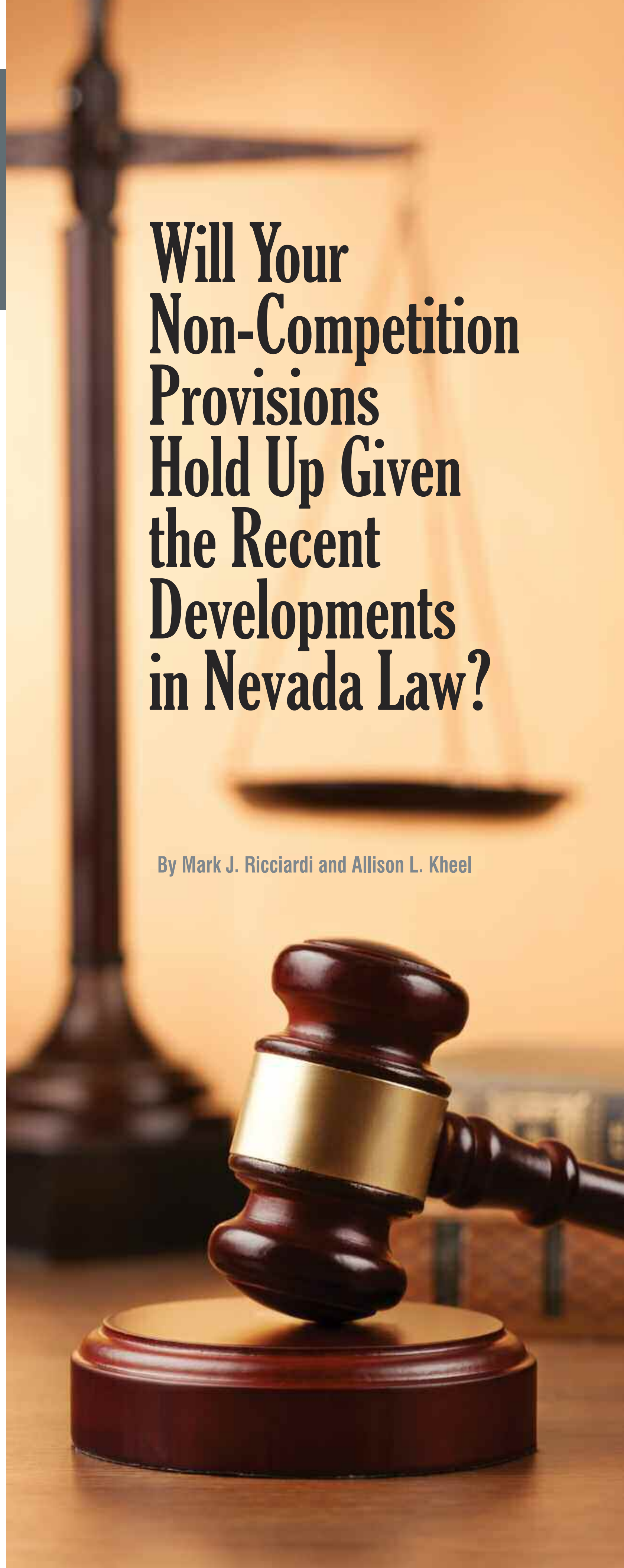

In the history of Nevada's non-competition laws, two of the biggest developments occurred within the last two years. Companies across Nevada need to review their non-compete agreements and make sure that they understand the effects of these new developments.[1] Unfortunately, while most businesses utilize a "non-compete" agreement in some varying capacity, non-compete agreements are often misunderstood.

Overview

Almost every successful business has two primary concerns: (1) what is the next "big idea" that is going to make the company money, and (2) how to protect the last "big idea" that is already making the company money. The "non-competition restrictive covenant," or "non-compete" for short, is the answer to the second question.

To discuss the area of law concerning "restrictive covenants" it is helpful to start with a basic understanding of the distinction between a non-disclosure covenant and a non-competition covenant.

NON-DISCLOSURE COVENANT: A non-disclosure covenant (also known as a confidentiality agreement) is essentially a contract with a former employee that limits the former employee's ability to disclose proprietary information or trade secrets both during and after employment. Non-disclosure agreements tell employees "do not steal the secret family recipe" (*e.g.*, computer algorithm, customer lists, proprietary information, etc.); do not tell anyone else the information; and do not open up a competing business using the company's own information to compete against it.

Notably, non-disclosure agreements generally do not specify time limits or geographic restrictions. Logically, this makes sense because the secret formula for manufacturing Coca-Cola is valuable so long as Pepsi does not learn the secret. If employees were free to share the secret formula one year after termination, the value of proprietary information and the incentive to innovate would be reduced to nothing. Non-disclosure agreements are commonly used for employees at all levels of the corporate structure who are exposed to proprietary or trade secret information. A bouncer at a club, a floor supervisor in the high limit area, or even some minimum wage employees might have a regular need to access confidential customer lists including gaming preferences and contact information.

NON-COMPETITION COVENANT: A non-competition covenant (or non-compete agreement) is quite different. A non-compete agreement precludes a former employee from competing with his prior employer for a specified period of time and within a limited geographic area. Non-compete agreements restrict the employee's ability to go to work for a competitor. While this sounds like an attractive business proposition, it is disfavored by the courts because it is also functions as a restraint on trade and often times prevents the former employee from earning a living in the only job he or she knows.

Also included under the umbrella of non-compete provisions are ***non-solicitation clauses*** (*e.g.*, do not steal the company's clients, customers, or sales contracts) and ***anti-raiding clauses*** (*e.g.*, do not steal the company's employees or entice them to go work at a new company). Companies invest significant money in employees to make and grow customer relationships, and these clauses are designed to protect those investments. Non-solicitation and anti-raiding provisions are subject to similar restrictions on reasonableness. However, as discussed further below, these provisions are often more complicated when it comes to real world issues of proof and questions of who made the first contact with the former employee or the client.

When attempting to enforce a non-compete agreement (*i.e.*, when a former employee is already working for a competitor and the company is losing business) the court will first consider whether the company has an enforceable non-compete agreement with the former employee.

To make this determination, the court will balance the burden placed on the employee against the potential harm to the employer's business and make sure that the burden is not greater than the amount necessary to protect the business interests that the employer sought to protect. Non-compete clauses must have reasonable restrictions. Otherwise, they will be found to be overbroad and unenforceable.

Due to these challenges, non-competition agreements should be used sparingly and are generally reserved for high-level key employees or executives who are likely to be privy to confidential aspects of the company's business strategy. Non-competes should be limited to situations where the employee will gain unique and intrinsic knowledge about the company, its customers, or its method of doing business that would harm the company if a competitor were to learn such information. Examples would include the company's plan to release a new game design or side bet; the company's plan to modify an existing table design to improve dealer efficiency (*e.g.*, adding the blackjack "peek"); the company's plan to switch to a new mobile gaming platform (*i.e.*, mobile sports betting), the company's plan to release a product featuring a new mathematical model or method of betting (*e.g.*, pari-mutuel "fantasy" football); or company's plans to expand into a developing but yet untapped market (*e.g.*, crypto-currency based, interstate Poker app).

Non-competes should be aimed at protecting the fundamental core of the business and the types of knowledge that an employee cannot "un-learn" or "un-see"[2] and that if a competitor were to learn such information while the company was in the development stages the competitor would be able to launch a similar product shortly after the company launched their product, diluting the company's expected profit. To be clear, a non-compete is not targeted at protecting the algorithms or underlying proprietary code (*e.g.*, refresh rate algorithm, mobile betting platform security encryption, etc.); rather non-competes are designed to protect the idea or concept (*e.g.*, it is horse racing, but the race is all NFL wide receivers playing on Sunday, most fantasy (PPR) points wins the race).

Once a company identifies what types of restrictive covenants it needs to protect different types of information used by employees in different types of positions, then the law starts to get tricky. Presently, the shifting legal framework in the area of non-competes can make the task of drafting an enforceable non-compete seem akin to navigating a minefield triggered by rotating laser grid. Thus, making it imperative that companies understand the recent developments in this area if companies are to have any chance of successfully enforcing a non-compete agreement.

Each of the recent developments and potential impact and implications will be discussed below.

Golden Road Opinion

In *Golden Road Motor Inn, Inc. v. Islam*, the Nevada Supreme Court held that state courts shall not modify – or "blue pencil" – non-compete agreements in order to bring them into compliance with the law. The Court explained that if a non-compete agreement contains even a single provision which "extends beyond what is necessary" to protect a company's interests, then the entire agreement will be deemed unenforceable.

In *Golden Road*, a casino host named Sumona Islam entered into an agreement with her employer, Atlantis Casino Resort Spa, to refrain from any type of employment with any other gaming establishment within 150 miles for one year following the end of her employment.

The Nevada Supreme Court found that the industry wide restriction in the non-compete agreement was overbroad and unreasonable, because it prevented Islam from working in any position at any gaming establishment. The Court hypothesized that if Islam were to obtain employment as a custodian in another casino, she would technically be in violation of the terms of the agreement. However, because it would be highly unlikely that she could lure casino players away from her former employer in such a role, the breadth of the noncompetition language was held to be unreasonable.

In essence, the Court held that Nevada companies got one shot to draft an enforceable non-competition agreement. Any single unreasonable or overbroad provision and the entire agreement could be void and unenforceable. The Court reiterated that there is no magic formula for an enforceable non-compete in Nevada and the inquiry must be whether the agreement is narrowly tailored to the specific needs of each individual company.

Statutory Revision and Enactment of NRS 613.195

New "Reasonableness" Analysis?

Following *Golden Road*, the Nevada Legislature revised the Nevada Statutes governing non-compete agreements. Assembly Bill 276 (2017), now codified as NRS 613.195 requires that a non-compete agreement must:

- Be supported by valuable consideration;
- Not impose any restraint that is greater than required to protect the employer;
- Not impose any undue hardship on the employee; and
- Impose appropriate restrictions in relation to the valuable consideration supporting the non-competition agreement.

In previous cases, the Nevada Supreme Court has held that "valuable consideration" for enforcing a non-competition agreement includes an employee's continued "at-will" employment.[3]

However, the Nevada State Legislature's decision to use the phrase "valuable consideration" in the statute raises some doubt about how this phrase will be interpreted in the future. Because the Legislature did not provide a definition of "valuable consideration," basic principles of statutory interpretation would suggest the courts should interpret this phrase in the new statute as having the same definition that the courts had given it

in the past (*i.e.*, continued at-will employment = valuable consideration). However, the new law also includes the limitation that the non-compete agreement "impose appropriate restrictions in *relation* to the valuable consideration supporting the non-compete agreement."[4]

This additional requirement suggests the need to conduct a proportionality inquiry, which, in turn, suggests that some forms of consideration may be inadequate to support a non-compete. It is possible that the Nevada Supreme Court (if it chose to enforce this portion of the statute) would view this "proportionality of consideration" factor as part of the reasonableness interpretation, in effect invalidating the principle that continued employment is sufficient consideration on its own to support any kind of non-compete agreement. Alternatively, the Nevada Supreme Court could limit the circumstances where continued employment will support a non-compete; or look to the nature and value of the continued employment as limiting the scope of the non-compete that would be deemed reasonable (*e.g.*, continued employment in executive level position with unrestricted access to company trade secrets might be adequate consideration to support a 12-month limitation, but continued employment in an entry level position with only tangential access to trade secrets might only be adequate to support some shorter limitation). As no case has yet presented a challenge to the Nevada Supreme Court regarding NRS 613.195, it is too early to predict the position the Court might take.

Moving forward, employers should consider incorporating additional forms of consideration into their non-competes to avoid any issues of enforceability. The courts use their equitable power when issuing an injunction and additional consideration increases the company's likelihood of obtaining an injunction. When considering an otherwise solid non-compete, many courts will enforce a 6 month non-compete if an employee is being paid severance for 6 months following their separation from the company. Additional signing bonuses for signing the non-compete will support broader restrictions than the continued at-will employment alone. Additional valuable consideration can also include non-monetary elements such as a provision limiting grounds for termination of employment to "just cause" or guaranteeing employment for a term of years. Employers should consider restructuring compensation to either provide for a signing bonus or make receipt of some portion of the employee's total regular compensation contingent upon signing the non-compete. Additionally, employers should identify all forms of consideration (both monetary and non-monetary) in the agreement.

Beware of the Reorganization Following a Merger

The new statute also limits the types of termination scenarios under which a non-competition agreement will be enforceable. The new statute provides that where an employee's termination is due to the employer's reduction of force, reorganization, or similar restructuring, then the non-compete agreement is only enforceable during the period when the employer pays the employee's salary, benefits, or equivalent compensation, including severance pay.[5] This restriction is designed to protect those "loyal" employees (employees who did not leave the company to pursue a competitive job offer and who were not terminated for cause), and who would have remained a dutiful and loyal employee of company had the company still been able and willing to pay their salary.

The greatest impact of this provision will be in the context of mergers, asset sales, and company reorganizations. As a general rule, non-compete covenants are personal in nature and unassignable as a matter of law. This means that a company (buyer) wishing to acquire valuable assets of another company (seller) does not also receive the protections of the non-compete agreement that the employee had with the previous seller-company, absent express consent. To obtain a transfer of the non-compete, the buyer-company must:

- Obtain the employee's express written consent;
- Negotiate (through "arm's length" negotiations) an express assignment clause; and
- Provide *separate consideration* for the assignment clause in addition to the consideration that was given for the original non-compete covenant itself.

In effect, this means that continued "at-will" employment with the buyer-company following an asset purchase will be insufficient consideration for the buyer-company to enforce the terms of a non-compete.

However, the Nevada Supreme Court held in *HD Supply Facilities Maintenance v. Bymoen*,[6] that the general rule of non-assignability does not apply when a successor corporation acquires the non-compete covenant as the result of a merger. The Court was careful to distinguish asset purchases (separate consideration required) from mergers (no separate consideration required).[7] *Id.* In effect, continued at-will employment for even one day following a merger was sufficient consideration to enforce the non-compete agreement against an employee.

Given the new proportionality requirement discussed above, it is now unclear if continued employment in the merger situation will be sufficient consideration for enforcement of an existing non-compete agreement.

Moreover, under previous merger case law, the successor company following a merger could reorganize the company and terminate employees with less than stellar performance after a brief transition period all while still enforcing the terms of the terminated employee's non-compete agreement.

Under the new statute's language regarding terminations as the result of a reorganization or layoff, it is now unclear whether the successor company following a merger can still enforce the terms of the terminated employee's non-compete without providing additional consideration in the form of severance. Without the benefit of acquiring enforceable non-competition covenants as part of a merger, the value of a company's goodwill and innovative marketing strategies might be significantly reduced without the corresponding protection afforded by the company's non-compete agreements. The cost of paying severance benefits to many employees in order to maintain enforceable non-compete agreements will further affect the value of the company.

It is presently unclear whether the Nevada Supreme Court will enforce this new statute, declare it unconstitutional, or enforce some portions of the statute while overturning other portions. But even partial enforcement has the potential to significantly affect the calculus and value placed on a merger for the successor company. Thus, companies considering mergers, asset sales, and other forms of restructuring should closely watch for any new developments concerning non-compete agreements.

Clarifying Restrictions On Providing Services to Former Customers Who No Longer Do Business with the Company – i.e., the "They Came To Me" Problem

The new statute also includes limitations on solicitation of *former* customers and former clients by *former* employees. The statute provides that if a non-competition covenant contains a provision that attempts to prevent the former employee from providing services to a former customer where either (a) the former employee did not solicit the customer or client, or (b) the customer or client voluntarily chose to leave and seek services from the former employee, and the former employee is otherwise complying with the limitations in the non-compete agreement concerning time, geographical area, and scope of activity to be restrained, then that provision (but presumably not the whole non-compete agreement) is void and unenforceable.

This provision seeks to avoid previous unrealistic situations where agreements would attempt to prohibit a former employee from obtaining any business from a client of the former employer, even where that business fell into the lap of former employee, and the employee did nothing to seek out the business opportunity. Previously, the competitors of the former employer were often afraid to hire former skilled employees due to fear of being hit with costly litigation, effectively expanding the scope of the non-compete agreement beyond the narrow non-solicitation language actually contained in the agreement.

Consistent with recent policy directives announced by the U.S. Department of Justice targeting anti-poaching agreements (*e.g.*, an agreement between two companies not to hire the other's former employees) as potential anti-trust violations, the courts and the Nevada legislature all seem to be targeting restraints on the free-market economy and reasonable competition.

Safe Harbor and Blue Penciling

Finally, the new statute adds two important protections for employers. The first safe harbor is NRS 613.195(3), which provides that an employer who negotiates, executes, or attempts to enforce a non-compete that turns out to be void and unenforceable (*i.e.*, overbroad under NRS 613.195) the employer does not face monetary penalties or misdemeanor charges under the anti-blacklisting statute, NRS 613.200. Essentially, this reiterates that good faith attempts to enforce a non-compete will not put an employer at risk for costly penalties if the court ultimately rules against the employer.

The second protection in the statute is the Legislature's attempt to partially abrogate *Golden Road's* "no blue penciling" holding by mandating that state courts must modify the agreement and specifically engage in "blue penciling." This means that where the court finds that the non-compete agreement is supported by valuable consideration, but one or more of the limitations (time, geographical area, scope of activity, etc.) is found to be overbroad, the court must revise the agreement so that the limitation does not impose a restraint greater than necessary to protect the employer. For example, if the agreement says 12 months but the court finds only 6 months is reasonable, the new law says the court must revise the agreement to say 6 months.

Is "Blue Penciling" under NRS 613.195 the Saving Grace it is Being Billed as?

While the legislative directive in NRS 613.195(5) states "the court *shall* revise the covenant to the extent necessary and enforce the covenant as revised,[8] it is presently unclear how the Nevada Supreme Court will react to the new legislative mandate requiring the courts to affirmatively engage in "blue penciling." The statute's use of the mandatory term "shall" instead of the permissive term "may" instructs the courts that they must assume the role of the drafter and retroactively revise an agreement to be enforceable. This hypothetically allows employers to implement knowingly overbroad and far reaching restrictions and puts the burden on the court to determine what would be appropriate, after an alleged violation has already occurred.

One could foresee enforcement scenarios under this statute where courts might be inclined to "split the baby" and find that a reasonable restriction would be somewhere in the vicinity of the former employee's actions. The result of this would be that companies might pursue costly enforcement actions with little tangible results.

Additionally, the Nevada Supreme Court has already indicated its disapproval of the "blue penciling" approach. Thus, companies should resist the overbroad, "everything under

the sun" approach to drafting. In *Golden Road*, the Nevada Supreme Court specifically noted that the Georgia Legislature tried a similar approach in 1990, only to have the Georgia Supreme Court deem the legislative attempt to advance blue penciling as unconstitutional. Additional dicta indicated the Court's feelings and inclinations. First stating that because the employer (and drafter of the agreement) "holds a superior bargaining position," the court will not provide further aid to the employer by editing the agreement to preserve enforceability. Second, the Court expressed that the role of the courts should be limited to interpretation, not drafting and that the courts generally disfavor non-competes as restraints on trade. This dicta does not bode well for the enforcement of the mandatory "blue penciling" statute if and when a case reaches the Nevada Supreme Court. However, it is too early to predict whether the Court will overrule the entire statute as unconstitutional, overrule some portions of the statute and uphold others, or will find some method of statutory interpretation that harmonizes the text of the statute with the Court's holding in Golden Road while softening the harsh effects of *Golden Road's* "single bullet"/no "blue penciling" decision. The likelihood of each outcome could be influenced by the composition of justices on the Nevada Supreme Court and cannot be predicted until the hypothetical challenge case is presented on appeal to the Court.

However, even if the statute were to be upheld and enforced as constitutional (a result which does not presently appear likely), employers should still not rely on the courts to revise every non-compete in every circumstance. The new law is intended to promote careful drafting and is not intended to rescue sloppy and hopelessly overbroad non-compete agreements. The Nevada courts place a premium on clarity and abhor the thought of engaging in a total re-write of the entire agreement. Thus, the clearer the non-compete, the more likely it is to be enforced.

Moving forward, the most prudent option is to carefully review the company's non-compete agreement and ensure it is reasonable, thereby obviating the need to rely on the courts to revise the provision in the first place. Employers should preemptively spend significant time considering the scope and necessity of their non-compete agreements and draft the agreements to match these needs. Companies should outline the facts supporting the reasonableness of the restrictions in the text of the non-compete agreement, to streamline future judicial review and increase the likelihood of obtaining swift injunctive relief while decreasing protracted enforcement litigation. Finally, employers should approach blue penciling as a fail-safe or measure of last resort, rather than an invitation to forgo conducting a meaningful review for "reasonableness."

The LinkedIn Problem

Another issue companies face when attempting to craft enforceable non-competes is the fact that the law almost never keeps pace with technology. The use of social media networking platforms to target potential clients and solicit business is constantly increasing, even bordering on necessity in some sectors. Unfortunately, the mechanisms of communication and the algorithms behind technology often create murky issues in the world of non-solicitation clauses.

Consider the following scenarios involving former employee (John Doe) of Company, who has now gone to work for a new company (NewCo):

- John updates his public Facebook profile page to simply list that he now works for NewCo.
- NewCo posts John's bio on its public website and posts a welcome message on its homepage announcing its new addition to its marketing department.
- John sends out "invitations" to Company's clients on LinkedIn inviting them to connect with him. Is this different if John only sends invitations to Company's former clients who are no longer current clients of Company?
- John is already connected to the client contacts on LinkedIn, but uses LinkedIn to send out a mass notice to all of his contacts saying "I now work for NewCo, call today for a quote." What if John posts the same statement in a public Tweet on Twitter?
- Is this different if the LinkedIn algorithm automatically generates a mass e-mail notification to all of John's connections simply stating "John has changed jobs."
- John sends a "direct message" to current Company employees encouraging them to come work for NewCo. What if John just constantly posts status updates about how great it is to work for NewCo and generally concludes each post with "NewCo is always hiring, call me if you want to apply?"

What scenarios are attempts to solicit former clients to do business with his new company and what scenarios are merely providing public information? What scenarios are targeted attempts to solicit former co-workers to work for the new company versus simply being excited about his new job? Courts across the country are struggling with issues such as these, but it remains unclear whether (and to what extent) a restrictive covenant can limit a former employee's social media usage.

Companies must consider these (and other) scenarios involving social media when drafting non-competes. Companies should examine whether their current policies restrict current employees from using social media and what types of limitations on social media usage would be reasonable. As with other drafting issues, clarity is the company's greatest weapon to achieving enforceability. Employers should consider adding examples comparing permissible and prohibited contacts using social media, and should review and revise their internal social media policies to be consistent with these non-competes.

While no one list can account for every variation and scenario a company may face in drafting or revising a non-compete agreement, below is a list of tips to consider when trying to draft an enforceable non-compete agreement in this uncertain legal landscape.

- State the factual basis and/or necessity for each restriction so the reviewing court can better evaluate the reasonableness.
  - Actually plot your competitors on a map before describing the geographic scope.
  - There is no requirement to describe the area in terms of a specific radius of distance, more descriptive areas are often considered more reasonable (*e.g.*, the resort and hotel corridor generally referred to as "the Las Vegas Strip" including the area of S. Las Vegas Boulevard between E. Charleston Blvd. and E. Sunset Road).
  - Consider also identifying your competitors by name, by way of example, to further guide the reasonableness of the geographic scope.
- Describe your industry and the information or key areas of business that your company is trying to protect.
- Describe the job functions the company is trying to protect not just the job title.
  - Always consider the company's response to the question: "If this individual gets a job working as a janitor for a competitor, how will that affect the company?"
- Be reasonable in time limitations (remember the company is preventing someone from working).
  - State any industry specific time limits that would make the time limitation more reasonable (*e.g.*, new products are released in November every year; the typical testing and approval period for a new product is 15 months, etc.).
- Mitigate potential risks to enforceability and offer a benefit beyond continued employment, such as a one-time cash bonus or a pay raise.
- Identify all forms of additional consideration in the agreement, even if not strictly monetary in nature (*e.g.*, promotion, additional supervisory authority, new specialized training, new office/parking space, change in sales territory, "just cause" termination provision, etc.) or any additional fact that should be considered in a proportionality analysis.

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[1] The Nevada Supreme Court has over the years issued a number of decisions deciding whether a non-compete's particular geographic scope or duration are reasonable and enforceable. The analysis of geographic scope and duration continues to be fact specific and neither *Golden Road* nor the new statute expressly overrule any of those cases.

[2] Similar to seeing the letter "V" appear in the Vegas Golden Knights logo, once it is identified, a person cannot "un-see" the letter contained in the negative space.

[3] *See Camco, Inc. v. Baker*, 113 Nev. 512, 517, 936 P.2d 829, 832 (1997).

[4] Nev. Rev. Stat. § 613.195 (emphasis added).

[5] *Id.*

[6] 125 Nev. 200, 210 P.3d 183 (2009).

[7] 100% membership sales of a limited liability company and 100% stock sales of a corporation are also exceptions to the non-assignability rule and do not affect the enforceability of restrictive non-competition covenants. *See Excellence Cmty. Mgmt. v. Gilmore*, 131 Nev. Adv. Op. 38, 351 P.3d 720, 722-723 (2015).

[8] Emphasis added.