The Business Ethics Center of Jerusalem

ONLINE HI-TECH MAGAZINE: Covenants not to Compete

Introduction

In the Hi-Tech sector, the value of a company is based on its trade secrets and intellectual property. Protecting trade secrets relies on the good will of the employees, but in today's competitive market, companies find that relying on an employee's sense of loyalty may not enough to protect its vital trade secrets.

One common method to ensure that trade secrets are not shared with competitors is through the use of *Covenants Not to Compete*, also known as *Non-Compete Clauses*. By signing a covenant not to compete, the employee promises that if he leaves the company, he will not go to work for a direct competitor. These excessive restrictions on an employee's ability to choose his place of work make this an emotionally charged topic.

Legal Issues

Covenants not to compete are written to protect the company, but it is feared that they could be used to unfairly restrict the ability of people to find employment. To prevent this, courts across the world have said that in order to be legal, covenants not to compete must meet the requirement of Reasonability. Courts judge if a covenant is reasonable by asking: Are the limitations established in the contract reasonably necessary in order to achieve the stated objective of protecting trade secrets?

Reasonability is proven on two main characteristics: **time** and **location.** Covenants not to compete state that an employee cannot work for a competitor for a set amount of time. Due to the dynamic pace of the Hi-Tech industry, this is typically one and a half years. Covenants not to compete also state that a former employee cannot work for a competitor in a certain geographic area. In the non Hi-Tech world, this is typically an area of 3-5 miles from the company. However in the Hi-Tech world, as companies compete as much with those next door as those across the world, these restrictions are often irrelevant and non-existent.

A company must prove in court that it has a legitimate business interest in enforcing a covenant not to compete. If it can prove this, the court may prevent an employee from going to work for a competitor or may order him to leave his current job with the competitor. Similarly if a company hires an employee and is aware of his covenant not to compete with his former employer, the new employer may be held liable in court for aiding the employee to violate the terms of the covenant.

If an employee leaves a company, it is legitimate for him to use and exploit general job skills that he gained while at the company, but disclosure of specific company secrets is not allowed. Employees benefit from company training courses, and from on the job experience, but this cannot be considered intellectual property. In certain jurisdictions, courts have confirmed that an employee cannot take confidential trade secrets from his

employer, but acknowledge that the employee is allowed to go to a competitor even if he has gained experience while in his previous job.

Ethical Issues

A common mistake people make is to assume that anything that is permitted by law must also be ethical. However, this is not necessarily the case. Just because covenants not to compete are permitted by law, does not mean that they are the correct course of action for a company. Just because covenants not to compete may not be legally enforceable in many circumstances does not meant that employees should ignore their ethical obligations to their previous employer. "Sometimes the law gives us an excuse to ignore whether the action we are taking is right or wrong," writes Jeffrey Seglin, an assistant professor at Emerson College and an ethics columnist for the New York Times, in his recent book The Good, the Bad and Your Business.

When an employee leaves and goes to a competitor, companies are quick to bring the employee to court, but are slow to consider whether this is the right this to do. "Much of the litigation could be avoided, however, if the people involved would focus on their ethical and moral dilemmas rather than on their strictly legal rights," says Roger Fine, Vice President and General Counsel for Johnson and Johnson. It is important for all parties involved to first consider the moral ramifications of their actions.

"The fundamental ethical principle involved is the right of every man and woman to try to work for a living, to have a job, to support himself and his family. An employer should be loath to interfere with this basic human endeavor. He has the ethical right to try to retain a talented employee by competing for his continued services through more compensation or better working conditions; he should be wary of using legal means to prevent his worker from working elsewhere." Companies need to remember that their employees are not property, and that if the employee decides to leave, it is his prerogative.

That said, the employee still has certain obligations to his company if he leaves, says Fine. The employee must refrain from taking and transmitting confidential information to his new employer. In addition when weighing a new job offer, the employee should consider whether he is being hired for his skills, or for the confidential information the he may bring with him.

"The competitor should be wrestling with moral dilemmas of his own," Fine adds. The company needs to ask itself, "Do I have a sudden vacancy that I'm trying to fill, or am I creating a new position in order to justify hiring my competitor's employee? Would I still be interested in hiring this person, with all of his talents, if he was not working for my competitor? Do I really need to have him work in the same area in which he worked for my competitor, or can I have him work for me in an unrelated part of my business for a period of time until the "secrets" he possesses become yesterday's news?"

As Fine explains, it is important to consider the ethical issues before the legal solutions, and try to find a compromise. It is necessary for all parties to consider the morality of their behavior, and to act in a way that is least harmful to involved parties.

The entire article by Roger Fine on this topic appeared in the Fall 1998 issue of Clear

Profit, a publication of the Center for Business Ethics. Click here to view the whole article.

The Case in Israel

In Israel, recent court decisions have severely limited the ability of companies to write covenants not to compete. "Freedom of occupation is now the law," says Eli Clark, a technology attorney in Herzliya, Israel who has worked both here and in the U.S., "that every person has a right to choose whatever occupation he wishes." Two recent legal cases have reinforced the basic right of the employee to choose his place of employment.

The Israel Supreme Court in August 2000 made a landmark decision concerning covenants not to compete in the case of AES Systems, Inc. v. Moshe Sa'ar and the State of Israel. The Court decided that a company can prevent an employee from going to work for a competitor only if it fears that the employee will disclose trade secrets, customer lists, or related materials. Even if an employee signs a covenant not to compete, he can only be bound by it in these cases. In a related case, the Israel National Labour Court recently determined that Hi-Tech companies can institute covenants not to compete for up to only nine months, and that anything beyond this will not be enforced.

The Israel Supreme Court chose a middle ground between two extremes: the liberal route of prohibiting all covenants not to compete, and the conservative route of allowing all contracts, even those which discriminate unfairly against employees. The court's decision prohibits general covenants not to compete which would prevent workers from ever working for a competitor, while retaining the right of the employer to protect itself by preventing the disclosure of its trade secrets.

The decision by the Israel Supreme Court confirms a previous decision by the Israel National Labour Court in 1999 in the case of Checkpoint Technologies Software v. RadGuard Limited. The court in this case struck down a restrictive covenant and allowed a manager to move between companies.

Precedents

These decisions are part of a trend in Israeli law, says Chaim Crown, General Legal Counsel for Versaware Technologies, an eBook publishing and distribution company in Jerusalem. Recent laws in Israel have encouraged freedom of employment and employee rights, all of which have created a liberal labour environment in favor of the employee. Thus the recent decision by the Israel Supreme Court was not a departure from previous policies, but confirmation of a trend.

The decisions in Israel were based on court decisions across the world, and especially in the US state of California. Courts in California have lead the way in striking down the enforceability of covenants, and this has been incorporated into subsequent legislation. The law even allows a former employee to solicit employees from his former employer as long as he does not use illegal means. However, companies are allowed to enforce covenants not to compete in order to protect their trade secrets and confidential information.

Israeli courts have not gone as far as their counterparts in California, allowing non-compete covenants in certain circumstances. "Israeli courts attempt to strike a balance between the competing interests of freedom of mobility of labour and the legitimate interests of an employer to protect its trade secrets and other confidential information," says Crown.

The Future

Many companies fear that the Israel Supreme Court decision will hurt them, as it may encourage employees to leave their employers. "I think it's unacceptable," says Adi Bildner, Director of Corporate Human Resources at Indigo, an international leader in the digital printing industry. Bildner fears that "an employee with valuable knowledge [of trade secrets] gained in a company, may decide to go to another company, and use the knowledge against [the interests of] the first company." Bildner notes that he is generally in favor of the trend of liberalism in Israeli society, but believes that courts should decide on a case by case basis in issues of covenants not to compete.

Crown however is optimistic about the future of Hi-Tech industry, citing the example of California. Covenants not to compete became illegal in California in the early eighties, preceding the explosive growth of Silicon Valley. "California courts relaxed the restrictions on employees, and as a direct result of the relaxation, it gave rise to the growth of Silicon Valley. This allowed brainpower to move with ease from one incubation house to another incubation house, from one software company to another software company. Because of the movement of labour, innovation flourished, and this created Silicon Valley." The laws in California attracted a lot of talent and financial resources, which helped to make Silicon Valley what it is today. Crown says that he expects the same movement of talent and money to Israel as a result of the court decisions.

Companies in Israel, as well as international VC firms and investment houses at first expressed concern about the new laws in Israel. Crown says that this was also the case in California, but the fears were proven false. "Companies were initially against it, because each company is an island of its own. But nothing breeds success like success, and the creative environment attracted investment, so the initial fears of management were alleviated when they saw the money and the increase in innovation."

As a result of the laws in Israel, companies generally cannot rely on non-compete clauses, but companies are still taking steps to protect themselves. Versaware distributed a letter to all of its employees, reminding them of the trade secret laws and of their obligations to the company. While not an official non-compete covenant, the letter serves to remind employees of their obligations of confidentiality, as well as to explain what the company considers to be confidential information. The company also requires any employee who wishes to leave sign a letter before leaving, saying that they won't transmit confidential corporate information to their new employer.

For more information

- An article analyzing how covenants not to compete encourage the growth of Hi-Tech appeared in the NYU Law Review, June 1999. Click here to view the article.

Suggested Guidelines

The Center for Business Ethics and Social Responsibility is developing a code of ethics for the Hi-Tech sector. The following guidelines on the issue of covenants not to compete are extracted from the code:

- Employees should be scrupulous not to take advantage of confidential information gained at a previous employer, particularly to the detriment of the previous employer.
- Companies should make clear to new employees that they are being hired for their skills and not for the confidential knowledge gained at a previous employer. This notification should ideally be provided in writing and formally acknowledged by the employee.
- Recruitment of a potential employee should not be carried out with the intention to obtain access to another company's trade secrets.
- Companies should not put pressure on employees to reveal secrets belonging to their previous employers.

Perspective From Jewish Sources
by Dr. Meir Tamari

It is natural when discussing job security and labor mobility to concentrate solely on economic and financial aspects. Without detracting from the importance of these materialistic aspects, it is important to also address the social and spiritual perspectives of employer-employee relationships. These perspectives center on the freedom of the individual and the protection of the employer.

In Jewish Law, or Halacha, the employer-employee relationship is one of hiring, similar to that of machinery, real estate, work animals, etc., and as such is regulated by the contractual obligations and the customs of the marketplace or of the local community. These customs come to protect both parties against misunderstandings or exploitation since they are operative even when not explicitly mentioned in the contract. However, as distinct from all other forms of hiring, labor relationships are about people and therefore halacha provides extra sensitivity to human needs.

Jewish law does not allow personal subservience of a worker nor a requirement of loyalty to the employer. This is learned from a statement in the Talmud, "The children of Israel are my servants, but not the servants of other servants." (Talmud Bavli, Bava Kama 116b) The Torah warns Jews against selling themselves into slavery for excessive periods. G-d reminds us that we should be servants only to Him, and not to other humans. Jewish law upholds the right of the employee to choose and transfer between jobs.

Workers may cease or withhold their services at any time; subject, of course, to payment for any resultant damage or loss to the employer. The employee, however, should not do so capriciously but only when there is no longer enough work or profit. He also must refrain from harming his previous employer.

Rabbi Yitzchak Weiss, a leading religious court judge in Manchester, England and Jerusalem, ruled on the issue of competition with previous employers, "We cannot

prevent Shimon from opening up his own business in competition with Reuven, even though he gained all his skills from his previous employer. To do so, would make him always dependent on Reuven as a servant... However, Shimon may not damage Reuven's livelihood by stealing, as it were, his customers [or suppliers]. So for a period of 3 years, Shimon is not allowed to contact or use them." (Minchat Yitzchak Part 2 Sect. 94)

There is plenty of evidence of communal legislation in the autonomous Jewish communities, and of the use of the rabbinic authorities to monitor agreements in restraint of trade. Jewish law has always tried to strike a balance between the rights of businesses and of employees, and so says that a person has the freedom to choose his occupation, but is not allowed to harm a previous employer by stealing his intellectual property, client lists, etc.