

CBA Labor & Employment Law
Non-Compete Agreements and the *Phoenix Capital* case: Into the Voidable
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I. INTRODUCTION

Many Colorado attorneys encounter covenants not to compete, most often in one of two contexts: employment relationships and sales of businesses. In the business sale context the noncompetition agreement is directed at preventing the seller from competing with the buyer. In the employment context, the agreement is directed at preventing employees from competing with their employers using resources and information provided by the employer or gained from the employment.

Exceptions to Non-Enforcement:

Pursuant to C.R.S. § 8-2-113, 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 is void, but the following exceptions apply:

- (a) Any contract for the purchase and sale of a business or the assets of a business;

The non-compete agreement associated with the sale of a business is for the protection of company goodwill. A general observation may be made that the courts are more solicitous regarding the strict enforcement of covenants-not-to-compete in an employer-employee context than in the sale of a business. Courts apply a more liberal interpretation to a business transaction than to an employer-employee relationship. *Keller Corp. v. Kelley*, 187 P.3d 1133 (Colo.App.2008) (covenants not to compete in employment contracts are more strictly construed than covenants not to compete contained in contracts for the sale of a business).

- (b) Any contract for the protection of trade secrets;

If the agreement relied upon is one for the protection of trade secrets, such agreement, by its terms, must be narrowly tailored for that protection. *See e.g. Gold Messenger, Inc. v. McGuay*, 937 P.2d 907, 910 (The purpose of a covenant not to compete must be the protection of trade secrets, and the covenant must be reasonably limited in scope to the protection of those trade secrets.)² Employers may not use the permitted exception for trade secret protection to transform an otherwise naked covenant not to compete which is void into an enforceable agreement. *Colorado Accounting Machines Inc. v. Mergenthaler*, 609 P.2d 1125 (Colo. App.

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² While the Court in *Gold Messenger* did not apply the “sale of business” exception to the creation of a franchisee agreement through a purchase from the franchisor, two federal court decisions have now done so. *Dry Cleaning to Your Door, Inc. v. Walham Limited Liability Company*, 2007 W.L. 4557872 (D. Colo. 2007); *I Can’t Believe it’s Yoghurt v Gunn*, 1997 W.L. 599391 (D. Colo. 1997).

1980) (where separate trade secret provisions protected employer's interest, and restrictive covenant was not limited to enhancing that protection).

- (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;

No reported Colorado case has applied this exception. However, in *Dresser Industries, Inc. v. Sandvick*, 732 F.2d 783, 788 (10th Cir. 1984), the Tenth Circuit found that this section of the statute did not apply, where the employer had incurred costs providing training to employees who quit before two years of employment, because the employment agreements at issue did not include provisions requiring repayment of such training costs.

- (d) Executive and management personnel and officers and employees who constitute professional staff to executive and management personnel.

The "executive and management personnel" exception applies to employees who are "in charge" and act in an unsupervised capacity. *Atmel Corp. v. Vitesse Semiconductor Corp*, 30 P.3d 789 (Colo. App. 2001); and *Porter Indus., Inc. v. Higgins*, 680 P.2d 1339 (Colo. App. 1984). Until recently, the phrase "professional staff to executive and management personnel" has not been interpreted by Colorado courts.

If not void, the covenant also must be reasonable:

When a covenant not to compete is statutorily permitted, it is enforceable only if it is reasonable in duration and scope. *Nat'l Graphics Co. v Dilley*, 681 P.2d 546 (Colo. App. 1984). To be reasonable, it must not be broader than necessary to protect the promisee's legitimate interests, and it must not impose hardship on the promisor. *Whittenberg v Williams*, 135 P.2d 228 (Colo. 1943)

Questions That Have Arisen:

Throughout the years, practitioners in this area have seen a number of unanswered questions develop, among them: 1) whether an employer can "grow into" the role of management and validate a previously executed non-compete, 2) what does "professional staff to executive and management personnel" mean, 3) is a non-solicitation of customers clause the same as a non-compete, 4) is a non-solicitation of employees clause treated the same as non-solicitation of customers clause under the statute, 5) the contours of the "assignability" of non-competes. Recently, a Colorado case addressed each of those issues – *Phoenix Capital, Inc. v Dowell*.

II. PHOENIX CAPITAL, INC. V. DOWELL, 176 P.3d 835 (COLO.APP. 2007)

A. Facts of Case

In *Phoenix*, the plaintiff (“PCI”) was an investment bank that provides analytic and brokerage assistance to financial institutions. The defendant employee became employed as a senior portfolio analyst. In 2000, Dowell signed an agreement with PCI, under which he was prohibited, in the event he left PCI’s employ, from competing with PCI or soliciting its customers or employees for one year. The agreement further provided that it was binding and would “inure to the benefit of the parties, and [PCI’s] successors and assigns.” By 2002, Dowell became the head of PCI’s analytics division. Subsequently, PCI formed PAS as an independent company to undertake its analytical functions and transferred Dowell to manage the analytics division at PAS. In forming PAS, PCI executed a transfer agreement that provided, in pertinent part, at closing, PCI would “sell, transfer, assign and deliver to PAS, all the properties, assets, goodwill, and business of every kind and description, both real and personal, tangible and intangible, of the analytic services division.” PCI’s employment agreements were not listed in the transfer agreement.

In March 2005, Dowell resigned from PAS to join one of PCI’s competitors in forming a new company. According to PCI and PAS, Dowell began to actively solicit PCI’s clients, assist his new company in competing with PCI for brokerage work, and try to convince two of PAS’ key employees to join his new company. PCI and PAS sought to enforce the noncompetition and non-solicitation provisions in Dowell’s employment agreement. After a hearing, the trial court determined that Phoenix had not established a reasonable probability of success on the merits with respect to the non-competition provision. However, the trial court held that Phoenix was entitled to enforce the provisions addressing non-solicitation of customers and non-solicitation of employees. Both parties appealed the trial court’s preliminary injunction rulings.

B. **Covenant Not to Compete Must Be Valid at Time of Execution**

The Court of Appeals first held that the determination of whether an exception to non-enforcement applied is as of the date the employee signed the agreement, and not at any time thereafter. The Court found that if an exception did not apply when the agreement was executed, the agreement was void *ab initio*, which the Court equated with “void”, rather than “voidable”. The fact that Dowell may have later become a “manager” in a manner that would have satisfied the executive and management personnel exception was of no consequence, since the non-compete was invalid at the time he signed it. In support of its holding, the Court explained, “[a]n employer may always enter into new employment agreements as its employees take on additional responsibilities, and the employer, rather than the employee, has the obligation to protect the employer's best interests.”³

C. **New Definition for Phrase “Professional Staff to Executive Management Personnel”**

³ Employers should be careful to ensure that additional consideration be given here – such as a promotion, raise, bonus, vacation pay, or additional access to confidential information. *Rivendell Forest Products, Ltd. v Georgia Pacific Corporation*, 824 F. Supp 961, 968 (D.C. Colo. 1993), rev’d on other grounds, 28 F.3d 1042 (10th Cir. 1994)

The Court of Appeals then examined whether the "professional staff" exception applied, given the trial court's preliminary finding that Dowell did not fall within this exception because, although he reported to managers and executives, most of them doubled as sales persons and most of his work was sales support.

Colorado's non-compete statute fails to provide a definition of "professional staff to executive and management personnel." Hence, the Court of Appeals in *Phoenix* spent much time analyzing what "professional staff" means. But the real issue in *Phoenix* was the linkage of "professional staff" to executive and management personnel, and there the Court in *Phoenix* provides a narrow definition: "We conclude that the phrase 'professional staff to executive and management personnel' is limited to those persons who, while qualifying as 'professionals' and reporting to managers or executives, primarily serve as key members of the manager's or executive's staff in the implementation of management or executive functions."

Although Dowell reported to executives or managers, he did not serve executives or managers in terms of implementing management functions. In *Phoenix*, whether one is a "professional" is really subordinated to the issues of how much the so called professional helps implement management functions.⁴ The Court found that 80-90% of Dowell's work was in a sales support role and therefore did not fit the definition of "professional staff to executive and management personnel" at the time he executed the agreement.

D. Non-Solicitation of Customers

Given that Dowell did not fit within any exceptions to the general rule that covenants not to compete are unenforceable, the Court of Appeals next analyzed the enforceability of the covenant relating to solicitation of customers and other employees. Dowell contended, *inter alia*, that the non-solicitation provisions were unenforceable because the accompanying non-competition provision was not enforceable. The Court of Appeals agreed with Dowell, insofar as it related to his agreement not to solicit Phoenix's customers. However, the Court rejected his assertions insofar as they related to his agreement not to solicit Phoenix's employees.

The Court of Appeals determined that because an agreement not to solicit customers is a form of an agreement not to compete, the portion of the agreement prohibiting Dowell from soliciting clients or customers was void. The Court stated "there is no legal basis to enforce an agreement not to solicit customers, when § 8-2-113(2) would invalidate an agreement not to compete". Therefore, an agreement prohibiting an employee from soliciting customers must meet the same strict standards as a prohibition from working for a competitor. The Court determined that in order to make a living, the former employee needs to be free to solicit (actively or passively) former customers, as long as he or she does not use the employer's trade secrets to do so.

⁴ For instance, the question of whether "industrial hygienists" in *Occusafe, Inc. v EG&G Rocky Flats, Inc.*, 54 F.3d 618 (10th Cir. 1995) are "professional staff" or not is probably irrelevant, since in no event would they have been involved in the implementation of management or executive functions.

E. Non-Solicitation of Employees

With respect to solicitation of other employees, the Court of Appeals rejected Dowell's assertion that, as a matter of law, an agreement not to solicit a former employer's employees cannot be enforced when an accompanying noncompetition provision is determined to be invalid.

The Colorado Court of Appeals has considered the enforceability of non-solicitation agreements as applied to coworkers. *See Atmel Corp. v. Vitesse Semiconductor Corp.*, 30 P.3d 789 (Colo.App. 2001) (finding co-employee non-solicitation provision void and unenforceable to the extent it can be interpreted to prohibit those defendants from doing anything other than initiating contacts with plaintiff's employee. Therefore, the Court of Appeals found that a non-solicitation agreement the employee had signed meant his former employer was entitled to an injunction preventing the employee from contacting his former colleagues about coming to work for his new employer.). The Court of Appeals in *Phoenix* rejected the applicability of the *Atmel* distinction between active and passive solicitation efforts relating to employees, and upheld the trial court's enjoining of Dowell from active solicitation of employees (although based on its ruling, the Court seemingly would have upheld active or passive solicitation). The court stated that "an agreement not to solicit employees would not impair the former employee's ability to make a living."

F. Assignability of Non-Competes

Dowell argued that his employment contract was a personal services contract that could not be assigned because Colorado law "does not allow assignments for matters of personal trust or confidence, or for personal services. The Court of Appeals did not consider whether the employment contract was indeed a personal services contract, but instead focused on whether Dowell consented to the assignment. The Court found that he did because his employment agreement stated that the "Agreement shall be binding upon and shall inure to the benefit of the parties, and [PCI's] successors and assigns." The Court held that such language was sufficient to show consent. This is a roadmap for employers – make certain there is an assignability provision in the employment contract.

III. OTHER RECENT CASE: REED MILL & LUMBER CO., INC. V. JENSEN, 165 P.3d 733 (COLO. APP. 2006)

This case involves the issue of "reasonableness" with respect to the enforcement of two non-compete covenants. One covenant was provided in conjunction with employment and one in connection with the sale of a business, with the employment non-compete covenant considered "ancillary" to the sale of the business non-compete covenant.

A. Facts of Case

The employee, Jensen, was the general manager of a mill and lumber business and a minority shareholder of Reed Mill, the selling company. Jensen worked for Reed Mill from 1973 until 2002. In 1996, Reed Mill sold its operating assets to Vranian Enterprises (the

“buyer”). During the parties’ negotiations, it was agreed that each of Reed Mill’s shareholders would be required to sign a non-compete agreement. The purchase agreement provided that as consideration and necessary inducement for the purchase of the business, the selling company would not compete with Reed Mill for a period of three years following the closing date, in order to protect the goodwill being sold and to allow the buyer to establish itself in the market.

After the sale, Reed Mill distributed the proceeds to its shareholders in accordance with the percentages of shares. Jensen received \$50,000 for his shares and another \$9,857 as his pro rata share of the new company’s payment for good will. In addition, Jensen and other shareholders agreed to individually sign non-compete agreements. Jensen’s non-compete agreement was made pursuant to the asset purchase agreement. It contained a three-year prohibition against competition that would begin upon termination of Jensen’s employment, and continue for three years thereafter.

According to the decision, after the sale, Jensen “continued to manage and oversee” the new Reed Mill business as general manager and remained responsible for operations and sales. Thereafter, his responsibilities were reassigned, although he continued to be responsible for sales for a few more years. Jensen resigned six years after the original sale to the buyer and began working for a competitor. After Jensen began working for the competitor, Reed Mill sued him for breach of his non-competition agreement.

B. Non-Compete Agreement Ancillary to Sale of Business Must Be Reasonable

The trial court concluded that because the parties executed the non-compete agreement in connection with the sale and purchase of a business, the agreement was a permitted exception to Colorado’s statutory bar on covenants not to compete. In addition, the trial court found that Jensen, at the time of his departure from the buyer, was not an executive or management employee, and therefore the executive and management personnel exception did not apply (a rationale seemingly at odds with *Phoenix*, since it directs the inquiry of the employee’s responsibilities to the time of termination, not to when the covenant was executed). Finally, the trial court found no valid reason why Jensen, “a mere employee” and an owner of only a small percentage of the business, should be prohibited from competing with Reed Mill in 2002, six years after the closing date. Reed Mill appealed, arguing that although Jensen’s non-compete agreement was made in connection with the purchase agreement, the trial court erred when it concluded that the duration of the agreement was unreasonable. Reed Mill asserted that it was reasonable to begin the three-year non-competition period upon termination of Jensen’s employment “because Jensen possessed good will at the time of the sale and maintained that good will during his employment with the new company.”

The Court of Appeals disagreed with Reed Mill, and affirmed the trial court's decision that Reed Mill could not enforce the three-year noncompetition agreement because it was unreasonable. Even though Jensen executed the non-compete agreement in conjunction with the sale of the business, the agreement must still be reasonable with respect to time, scope and geographic limitation. The Court noted that Reed Mill enjoyed the protection of its purchased good will during the three years immediately following the sale of the business because Jensen did not compete with Reed Mill. Indeed, Jensen remained employed with Reed Mill for six

years and assisted the company in its efforts to convert that good will to its own, including preserving the patronage of past customers. Therefore, the Court rejected Reed Mill's argument that the rationale for commencing the term of the non-compete upon Jensen's termination was to provide the company time to convert the former company's good will into its own.

As a result, the Court of Appeals adopted the trial court's ruling and determined that Jensen's non-compete agreement executed in connection with the sale of a business, and not with Jensen's employment as a general manager of the old Reed Mill. It was unreasonable under the purchase or sale of a business exception to C.R.S. § 8-2-113(2)(a) to give the new employer what would, in effect, be a noncompetition agreement lasting nine years.

C. Executive and Management Personnel Exception

Reed Mill did not dispute that Jensen did not have executive or management responsibilities at the time of his termination from the buyer. Instead, Reed Mill argued that Jensen was the general manager with Reed Mill when he executed the non-compete agreement and that the agreement was made in connection with his employment before the purchase. The Court of Appeals disagreed. The Court of Appeals held that the purchase agreement explicitly stated that the purpose of the non-compete agreements was to ensure the continuation of the business, and therefore was to protect the buyer's purchase of good will. The Court of Appeals determined that because the agreement was not made in connection with Jensen's employment, it did not need to address whether the exception for management and executives applied.

IV. LESSONS:

The Colorado Courts, in these two decisions, seem to be looking at ways (which are sometimes inconsistent with one another), to avoid the enforcement of non-compete covenants. Employer's counsel will need to be more creative in working around the minefields in this area, and in properly advising clients as to the prospects for enforcing such covenants, which are made more difficult except perhaps under circumstances involving the highest level executives.