

Restrictive covenants: what are they and when and where can they be used

Should you be asking your employees to execute restrictive covenants to prevent them from exploiting your intellectual property, or luring away your customers or co-workers for the benefit of your competitors? Many employers answer this question with a yes. Restrictive covenants are governed by state law, which can vary widely by state. Several states have specific statutes that specifically address the enforceability of restrictive covenants (eg, California, Oregon, Texas and Wisconsin). But most regulate restrictive covenants thru common law. This article provides a basic overview of some of the key legal considerations in using these agreements.

Types of restrictive covenants

Restrictive covenants may contain 4 different types of promises: (1) a promise not to compete with one's former employer; (2) a promise not to solicit or accept business from customers of the former employer; (3) a promise not to recruit or hire away employees of the former employer; and (4) the promise not to use or disclose the former employer's confidential information.

Enforceability

Three states—California, Montana and North Dakota prohibit employers from asking their employees to sign restrictive covenants. California's ban further prohibits non-solicitation of customers. In the remaining jurisdictions, a covenant is enforceable only if it serves a legitimate purpose and is reasonable in scope, geography and time. These limitations vary from state to state, but the following legal framework is common across most jurisdictions.

- Legitimate purposes includes:
 - preserve confidential information
 - protect customer relationships
 - preserve goodwill
- The scope of the restrictions should be only as broad as needed to serve these interests:
 - For non-solicitation of customers, this typically means the restriction must be limited to customers or prospects with whom the employee has some responsibility.
 - For non-hire of employees, this typically means the restriction must be limited to employees with whom the former employee supervised, or with whom s/he worked.
 - A few states do not permit restrictions on "accepting" business or "hiring" employees. Rather, the former employee may only be prohibited from making initial contact with former customers or coworkers.
- Permissible durations typically range from:
 - 1-2 years in the employment context
 - 5-10 years in the sale of a business
- Geography:
 - Must be limited to where the Company does business and where the employee had responsibility

- No geographic scope is necessary for a non-solicitation of customers or employees

Is consideration necessary?

In most jurisdictions, employment at will, or continued employment is sufficient consideration to support the covenant. But some states require an employer to offer additional consideration. Some ways to satisfy the consideration requirement is to offer a candidate a signing bonus, or severance. For current employees, the consideration requirement may be satisfied by tying the receipt of an employee's annual increase or bonus to signing the covenant.

Should the covenant be included in an equity grant?

Restrictive covenants are often stand-alone agreements enforced by an employer through emergency injunctive proceedings. This process can be expensive and unpredictable. One alternative that companies use is to embed a restrictive covenant in an equity option, grant, or award of deferred compensation. The option, grant or then makes clear that future payments/awards are forfeited and amounts already paid may be clawed back if the employee breaches the covenant. These grants or equity plans provide employers options for less expensive, self-help remedies that may act as a golden handcuff.

Key take away

Deciding whether to require your employees to execute restrictive covenants involves complex legal and strategic decisions. Before you decide to impose any restrictive covenant on your employees, it would be wise to consult an employment lawyer to understand the scope of a permissible covenant in the applicable jurisdiction.

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