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Law Regarding Enforcement of Noncompetition Agreements in Illinois Expands in Line with New York Law

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Introduction

Companies seeking to enforce covenants not to compete in Illinois, the largest corporate hub in the Midwest, now potentially have greater opportunities to do so. A recent Illinois Supreme Court decision expanded the criteria by which a company can establish a legitimate business interest justifying enforcement of the covenant, and in doing so, the Court cited favorably leading New York case law on the topic.

In recent years, Illinois law governing the enforcement of covenants not to compete has been unsettled, and this has caused confusion for employers and practitioners. The intermediate appellate courts over the years developed what had become a rigid, two prong test for determining whether there existed a legitimate business interest justifying enforcement of the covenant. Two years ago, the Appellate Court, Fourth District rejected the legitimate business interest test altogether, explaining in *Sunbelt Rentals, Inc. v. Ehlers* that a covenant not to compete would be enforced as long as the time and territory restrictions were not unreasonable. See Paul Hastings, Stay Current, Significant Change in the Law Governing Restrictive Covenants in Illinois, Nov. 10, 2009. In 2010, the Appellate Court, Second District, rejected the legitimate business interest test as well, in *Steam Sales Corp. v. Summers*.

Earlier this month, in *Reliable Fire Equipment Co. v. Arnold Arredondo et al.*, the Illinois Supreme Court expressly overruled Sunbelt Rentals and Steam Sales. The Court made clear that the legitimate business interest test is central to determining the enforceability of a noncompete ancillary to an employment agreement. The Court further held that the rigid two prong test established over a period of many years by the appellate courts—which had limited the legitimate business interest question to whether the employer was protecting confidential information or near-permanent customer relationships—was too restrictive and that courts should evaluate the totality of the circumstances in determining whether a legitimate business interest exists. Those earlier decisions, the Court noted, remain as precedent but serve only as nonconclusive aids for determining enforceability questions in future cases.

I. Background

The plaintiff in *Reliable Fire Equipment* sells, installs, and services portable fire extinguishers and a variety of fire suppression and fire alarm systems. The defendants were employed as salespeople for Reliable. In connection with their employment, the defendants signed restrictive covenants, promising not to compete with Reliable in Illinois, Indiana, and Wisconsin during their employment, and for one year after their termination. Additionally, they promised not to solicit any sales or referrals from Reliable customers or referral sources, or to solicit Reliable employees to leave their employment.

In March 2004, the defendants sought financing for a competing business, while employed by Reliable, and the following month formed High Rise Security Systems, LLC. Reliable's founder and chairman suspected that the defendants were planning to start their own business and compete with Reliable, so he approached them about their intentions to start their own business; they denied it. On September 1, 2004, one of the defendants resigned from Reliable. One month later, Reliable fired the other defendant, suspecting that he may be competing with Reliable.

Reliable filed a complaint against the former employees and High Rise, alleging, among other things, that the individuals breached their restrictive covenants by forming High Rise and competing with Reliable. Reliable sought a declaratory judgment that the noncompetition agreements were enforceable and sought damages for the alleged breach. After a bench trial, the circuit court held that Reliable's restrictive covenants were unenforceable because Reliable failed to prove that the covenant was needed to protect confidential information or near-permanent customer relationships.

Reliable appealed, and the appellate court affirmed in a divided opinion. The lead opinion applied the rigid two pronged test for determining whether Reliable proved that it had a legitimate business interest justifying the restrictive covenant. A special concurrence agreed that Reliable failed to prove a legitimate business interest but instead advocated for a totality of the circumstances approach to determine whether Reliable had a legitimate business interest. A dissenting judge also advocated for a totality of the circumstances approach but voted to reverse and remand the case for further proceedings. On appeal, the Illinois Supreme Court reversed the judgment and remanded the case to the circuit court for further proceedings.

II. Analysis

In Illinois as in other jurisdictions, a contract in restraint of trade is "undoubtedly void because it necessarily injures the public at large and the individual promisor." Yet, the Court explained, it is equally true that a covenant will be upheld if it is *reasonable* and supported by consideration. Citing to the Restatement (Second) of Contracts and the leading New York Court of Appeals decision on the subject, *BDO Seidman v. Hirshberg*, the Supreme Court made clear that a restrictive covenant in an employment agreement is reasonable "only if the covenant:

(1) is no greater than is required *for the protection of a legitimate business interest* of the employer-promisee;

(2) does not impose undue hardship on the employee-promisor; and

(3) is not injurious to the public."

This rule, the Court explained, was consistently applied by the Illinois Supreme Court from as early as the late nineteenth century.

In addition to expressly overruling *Sunbelt Rentals* and *Steam Sales*, the Court then reviewed more than thirty years of appellate court precedent regarding the legitimate business interest test. From its very early decisions, the appellate court variously adopted what had become "the *sine qua non* for the enforcement of a covenant not to compete"—which required that (a) the employee had acquired confidential information of the employer and intended to use it for his own benefit, or (b) the employer's customer relationships were near-permanent and but for his association with the employer, the employee would never have had contact with those customers. This two factor test, the Supreme Court explained, was too rigid, and improperly limited an employer's ability to seek enforcement of a noncompete.

"[T]he appellate court precedent for the past three decades remains intact," however. But, the Court explained, it remains "only as nonconclusive examples of applying the promisee's legitimate business interest." "[W]hether a legitimate business interest exists" to satisfy the first prong of the three prong reasonableness test "is based on the totality of the facts and circumstances of the individual case." Factors that may be considered include, *but are not limited to*, the near-permanence of a customer relationship, the employee's acquisition of confidential information during employment, and time and place restrictions. The Court noted that no one factor should be given more weight than another. And it suggested that exemplary facts presented in earlier cases should not necessarily be viewed "as the outermost boundary of the inquiry."

The Supreme Court reversed the judgment and remanded the case for further proceedings, finding that the parties had unfairly been limited in their presentations by the rigid two pronged test.

III. Conclusion

Given this new test, employers face a new imperative to think critically when drafting covenants not to compete about what business interests they seek to protect and how they seek to protect those interests. Under the new totality of the circumstances test, employers seeking to enforce covenants not to compete are no longer limited in how they can establish a legitimate business interest justifying enforcement. This new test creates more opportunity for creative lawyering and allows trial courts broader discretion to determine what constitutes a *legitimate* business interest sufficient to justify a restraint on competition. Where the courts will set the outer boundaries of this new test remains to be seen.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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