Noncompete Provisions

by Kirk Palmer – CEO
Kirk Palmer & Associates, Inc.

Protecting Company Assets, or Stifling Competition and Creativity in our Industry?

Framing the Issue

In 1993, few had ever heard of the term "noncompete provision". Ten years later, these clauses in employment contracts have become the norm rather than the exception for a number of executives at many of the larger retailers and wholesale manufacturers in our industry.

The purpose of this discussion is to examine reasons, realities and ramifications of noncompetes for our industry.

Simply stated, a noncompete provision prohibits an employee from leaving their employer to accept a position with a "competing" employer. The definition of a "competing" employer varies widely by contract and company. Does Federated compete with May? Most would say yes. But it's more complicated than that. Look at another example. Privately held Meijer Company operates 150 stores in five midwestern states, overlapping in 10 trading areas with May (such as Muncie and Lafayette, Indiana, Mansfield, Ohio, etc). No Meijer store is mall based. The stores, more akin to a WalMart Supercenter, average 260,000 square feet and consist of a full supermarket, house and garden area, apparel, pharmacy, pets, toys – over 40 different departments. Does Meijer compete with May? According to their executive noncompete provision, the answer is yes. A former May executive, out of work for over a year, was not permitted to consider a position within the company. Another example, not as extreme as Meijer, but intriguing – does Victoria's Secret compete with May? May says yes and is scheduled for a court battle with Victoria's Secret over the employability of a former executive (as of this writing, September 2003).

We are not singling out May Department Stores. Federated, Gap, Limited, JC Penney and many other larger retailers and wholesale manufacturers are following suit. There is clearly a trend to make noncompete provisions as restrictive as possible, without being deemed as unenforceable by the courts.

Noncompete Provisions

Basics of Employment Law

To frame the discussion, it is worthwhile to understand the basics of employment law. Most non-union employees in America work under a doctrine called "employment at will". In simple terms, "employment at will" means that an employee has the right to leave their employer at any time, for any reason and an employer also has the right to terminate an employee at any time, for any reason, provided the reason(s) do not violate state or federal discrimination laws. Employees who do not work under collective bargaining agreements or employment agreements generally fall into this category. For the most part, these people have the right to leave one company and go to work for another company of their choosing. However, when a person enters into an employment agreement, the terms of the agreement generally take precedence over the doctrine of "employment at will" and the rights of both the employer and the employee are then governed by the information contained in the employment agreement.

History of Employment Agreements in the Retail Industry

Employment agreements were originally devised to minimize the risk an executive felt in leaving a "secure" employment situation to go to a new company. The primary provision in employment agreements was to provide some sort of financial protection to the employee if the employer subsequently terminated their employment. This financial protection usually takes the form of severance payments, where the company agrees to continue to pay the executive at a specified rate for a specific period of time. These items are negotiated at the time of the job offer, prior to acceptance.

It is instructive to examine how noncompetes became a part of employment agreements, why they are becoming so pervasive and what the ramifications are to the industry. First, let's look at the nature of executive employment in our industry from an historical perspective.

In the 1960's and 1970's, companies such as Bloomingdale's and A & S were recognized throughout the industry for producing strong executive talent. Smaller, lesser known and second-tier companies were of course, interested in attracting "star talent" from "star companies". In order to induce these "high-flyers", companies began to offer employment agreements, which guaranteed employment and severance to offset the perceived risk of going to a "lesser" establishment from a more "secure" environment. While

these agreements had previously been used at the CEO and President levels, they began to gain acceptance at the next level down and then the level below that. As the perception of talent scarcity intensified, many employers felt they had to offer employment agreements with meaningful severance provisions to secure top talent. While there are a hundred variables in today's employment agreements, these earlier agreements tended to benefit the employee (in the way of guarantees and severances) more than the employer (because there were seldom noncompetes). It became known that one could often negotiate an employment agreement when moving to another company and certain companies were known for providing a level of protection. Other companies, usually those in a stronger financial position or with industry perceived prestige, decided that no executive (except perhaps the CEO and/or President) would have employment agreements, and if severance was considered, it would be applied as a total company policy, spelled out in the company manual.

The 1980's brought a wave of mergers, consolidations, reorganizations and closures that transformed the overall complexion of the retail industry (and subsequently the wholesale side as well). For many, job stability was next to non-existent and talented executives were merged, consolidated and reorganized from one company to another to another. These changes further boosted the perception (and reality) that employment agreements were necessary in an industry of constant change, where through no fault of ones own, one could find themselves unemployed.

During this decade, new language began to appear in contracts, designed to offer a measure of perceived protection to employers. Why should a company pay to train an executive, share its "secrets" and strategies, and offer severance protection, only to see that training and information used to a competitors benefit if the executive leaves to join a competitor? So went the argument and thus began the "era of noncompete provisions".

Into the Courts

By the 1990's, prominent legal disputes involving noncompetes began to occur. In 1990, Neiman Marcus sued Federated Department Stores for taking Allen Questrom from Neiman's to become its Chairman and CEO. The suit was subsequently settled for a substantial sum. Then, in the fall of 1993, Federated, with Allen Questrom at the helm, decided to take the role of Plaintiff. Roger Farah, Chairman and CEO of Federated Merchandising Services, was recruited by Macy's to become President and COO. Federated sued Macy's, alleging that the noncompete provision in Farah's contract prohibited him from going to a competing employer. Their argument was upheld in the courts. Macy's had to pay Farah's Federated salary while he sat on the sidelines, unable to work for Macy's for a specified time period. When he was finally able to join Macy's, he was on the job for three months and then Federated acquired Macy's. The "change of control" provision in Farah's new Macy contract allowed him to leave

Noncompete Provisions

the company and collect money due from his Macy contract.

In 1995, May Department Stores filed a suit against The Bon Ton Stores and Heywood Wilansky, it's former President and CEO of Foley's who had accepted the same position at Bon Ton. The basis of the suit was the "noncompete" provision in his contract. The lawsuit was settled, but not without May making its point that it would vigorously enforce the noncompete provisions in the contracts, which by this time, it had in place for it's executives down to the GMM level.

In 1998, Federated decided to vary its legal strategy to enforce its noncompetes, this time filing suit against Herbert Mines Associates, an executive search firm. The lawsuit accused Mines of having "wrongfully, intentionally and maliciously induced, or joined with Venator in inducing, Matthew Serra to breach his contract with Sterns". Mr. Serra was CEO of Federated's Stern's unit, and had joined Venator Footlocker Worldwide division as President and CEO. The suit was subsequently settled, the terms of which were undisclosed. A number of us in the search industry received a letter at the time from Federated, informing us of the action and communicating their intention to take an aggressive posture on the noncompete issue. The implied threat was clear.

In late 2000, May Department Stores demonstrated that it would seek to enforce its noncompete provisions below the Principal level, when it obtained a restraining order against Linda Knight Quick, to keep her from joining JC Penney. Quick had been SVP, Advertising and Sales Promotion for May's Houston based Foley's division. Quick said she sought work in Dallas so that she could live full-time with her husband, Mark Quick, who is president of Fossil Accessories. The pair had been married 18 years and commuting between the two Texas cities for the past five years. Her attorney stated, "Noncompetes have to be reasonable and this one we believe is unreasonable because it is so broad it would prevent her from doing anything, from working at Penney's or any other company that did more than $25 million, which takes out a huge segment of the industry." A May spokesperson said, "Linda Quick's acceptance of a position with J.C. Penney, one of our competitors, clearly breaches her contractual obligation with May. Ms. Quick had access to and used vast amounts of confidential information about May that can be very valuable to a competitor. We intend to enforce our rights vigorously." A trial date was set for six months after the restraining order and due to the circumstances, Penney chose not to wait to employ Ms. Quick.

Interestingly, the last contract Quick had signed expired in April of 1998, but May contended that the starting time period for her noncompete provision began when she departed the company in 2000. This agreement resulted in the restraining order prohibiting her from joining Penny until a trial to determine a final outcome. The trial never took place.

It is important to understand that not all noncompetes are alike. Some list specific companies the executive is prohibited from joining. The theory is that these contracts are more likely to be enforceable than those that prohibit "employment with any other retailer we view as a competitor". This is because broader noncompete language has been viewed (with some case law backing) as less enforceable, if they effectively block someone from earning a living in their chosen field. That said, May Department Stores has led the industry with very broad language in their noncompete provisions and has successfully enforced those provisions, through court action when it deemed necessary. If an executive under contract with May is either released or resigns their position, the company has the option to pay the executive, at full salary, not to work at what it deems a competitor, for the length of the noncompete provision, which is often up to two years. While this sounds fair and perhaps even appealing to some, most human beings naturally want to work, contribute and be productive. We have yet to meet an executive who wouldn't gladly give up being paid to do nothing in order to go back to work and be a productive contributor.

The Case for Noncompete Provisions

Companies that use noncompete provisions explain their rationale and thought process as follows:

1. The retail industry is highly competitive and success depends on a myriad of factors, including our ability to attract, train and develop, and retain a top quality and stable executive work force.

2. We invest the time, money, training and support to build a strong executive team, which gives us competitive advantage.

3. Our senior executives have access to and utilize proprietary information, systems and programs.

4. This information, and these systems and programs are confidential and could cause substantial and irreparable harm if shared or given to our competitors.

5. To protect our company and its shareholders, we have the responsibility to put into place tools that serve to protect the confidentiality of such proprietary information.

6. Our executives sign these agreements of their own free will, in exchange for generous compensation and our commitment to grow and develop them within our organization.

These arguments have been effectively made and upheld in

Noncompete Provisions

various courts. May, Federated and others have been able to enforce noncompetes on their legal strength, but they are obviously effective when going against individual executives who do not possess the same level of legal and financial resources. In addition, their aggressive posture on this issue has led many hiring companies to simply avoid candidates with noncompetes. Most will move on to candidates without noncompetes as they do not wish to engage in the court battle, even if they feel they could win on the legal merits. However, in an important exception, in June 2003, Victoria's Secret Stores filed suit against May Co., which was seeking to block their efforts to recruit Mark Weikel, former chairman of May's Houston-based Foley's division. Weikel, had been offered a senior-level position at Victoria's Secret. In the suit, they contended that Foley's was not a competitor to Victoria's Secret and therefore hiring Weikel did not constitute a violation of noncompete restrictions written into Weikel's contract at Foley's. A court date has been set for early October 2003 and we will be most interested to see if both companies actually argue the issues in the courts. The resulting ruling could have substantial impact on the viability of the broad noncompete provisions that have become so prevalent.

The Case for Moderation

In a short period of time, noncompetes have risen from obscurity to making a significant impact on our industry. From the Seventies, Eighties and into the Nineties, executives often moved from one company to another, broadening their skill set, gaining new and different perspectives and bringing "fresh eyes" and passion to their new employers. How did this industry survive in the pre-noncompete era? We would argue, just fine. The vast majority of executives who today lead the largest retail and wholesale manufacturers have worked for a number of companies on their way to the top. We think this is good for the companies they run. Noncompetes, as they are currently worded, structured and enforced, will eliminate the ability of companies to populate their executive work force with talent from diverse and different backgrounds. The debate now needs to focus on what good versus what harm is occurring to individual companies and to the industry due to the extreme restrictiveness of non competes, as they currently exist.

We understand that some form of noncompete provision at certain levels and in certain industry sectors has viability. However, the breadth, scope and duration of these provisions have, in our view, become overly restrictive. For a $15 billion corporation to prohibit

someone from working in any company that sells $25 million in any similar product category is taking the noncompete concept to an extreme. This scope and breadth effectively bars the executive from working in the general retail industry. Furthermore, and to the heart of the matter, we must ask the question, "What kinds of secrets does a GMM possess from, say a Federated, that would cause 'substantial and irreparable damage' to Federated should that executive accept a position at, say The Limited? And if they do indeed possess secrets, at what point do those secrets lose meaning? After 6 months? One year? Two years? And if they possess these secrets and must be prohibited from working in the retail industry for up to two years, what about the secrets known to DMM level executives? How about Buyers? What about the executive secretaries? Other non-merchant functions? At what point does this get plain foolish? And what kind of "substantial and irreparable damage" has occurred at these companies? Each clearly has experience with executives leaving to go to other companies and each has experience in hiring executives from other companies. Limited has executives from Gap and vice versa. Ann Taylor has executives from J Crew and vice versa. Bed Bath and Beyond has executives from Linens N Things and vice versa. May has executives from Federated and vice versa. Etc, etc. Has this helped or hurt these companies and the industry in general? We would argue that a balance of internal promotions and external hiring is good and healthy for a company. It keeps internal executives motivated because of advancement opportunities and also brings new and much needed fresh perspectives to each company. Importantly, it allows companies to continually benchmark their own talent pool with what exists on the outside.

The reality is that the proliferation of noncompetes creates an industry-wide culture of "indentured servitude" among executives. It is fundamentally altering executive movement and will fundamentally alter the composition of talent within companies. By their very definition, noncompetes are anti-competitive. Worst of all, the "era of noncompetes" has led to a significant number of disgruntled, unhappy and/or disillusioned executives who, feeling trapped, trudge into their jobs, unmotivated and bitter, providing just enough mediocre performance to insure the perpetuation of their position. The result is an industry where more and more of its senior leadership feel trapped, having lost passion and creativity to move this industry forward.

We believe that companies have the right to protect bona fide "secrets" from direct and obvious competitors. But the time has come for all companies to re-examine and get realistic about defining three major components related to noncompetes.
They are:

Scope of "Competition" – We all know Federated competes with May. Restrict noncompete provisions to the companies that are the obvious competitors.

Noncompete Provisions

Length of Noncompete – In this age of daily change and instant information, in this industry of constant change, we find it difficult to believe that anyone can possess such secrets to create "substantial and irreparable harm" after having been out of a company for more than six months. After this time period, an executive should have the right to go back to work, and upon new employment, cease receiving any compensation from their former employer. There are too many examples where a company has been downright vindictive to executives, forcing them not to work for two years, in order to "make their point" to the rest of the industry. It's wrong.

Participants – Noncompete provisions should be restricted to those who truly have bona fide and highly proprietary information. This may vary by company, but is generally not more than the most senior members of management.

The issue of noncompete provisions is complex, with valid arguments on both sides of the fence. Our intent is to foster a meaningful discussion, as we believe it to carry broad ramifications throughout our industry. We clearly believe that moderation and thoughtful common sense will yield the greatest benefits for both employee and employer and we welcome your thoughts and comments. ■

NEW YORK
500 Fifth Avenue, Suite 1500
New York, NY 10110
t 212.983.6477
f 212.599.2597

BOSTON
306 Moulton Street
Hamilton, MA 01982
t 978.468.2485
f 978.468.6122

CHICAGO
122 Maumell Street
Hinsdale, IL 60521
t 630.321.0535
f 630.321.0537