Enforceability of Restrictive Covenants in Distributorship and Independant Contractor Agreements

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I. INTRODUCTION

Virtually every business depends upon the sale of products or services for its survival. An effective sales force is therefore a crucial ingredient for the success of any business. Most companies invest heavily in their sales personnel, ensuring that they possess sufficient knowledge of the company’s products, services and customers in order to increase their market share. Typically, this requires the company to disclose highly confidential and proprietary information to its sales personnel, in the hopes that they will use that information to increase revenue for the company.

Companies are therefore understandably concerned about protecting their investments in their sales personnel, and commonly take measures to ensure that the company’s confidential and proprietary information remains secure. For example, many companies ask their employees to enter into restrictive covenants, which are designed to constrain employees from soliciting customers, disclosing confidential information, and engaging in prohibited activities during the term of their employment and often for some time period thereafter. Such restrictive covenants are so commonplace that nearly every sales person has likely been asked to sign one at some point in his/her career. The enforcement of a restrictive covenant against a former key employee often results in litigation. Each year, there are hundreds (if not thousands) of lawsuits, and dozens of reported opinions, analyzing the enforceability of such restrictive covenants in the context of employment agreements.

But, not every business has an in-house sales force. Instead, many companies rely upon distributors (or other independent contractors, such as “agents,” “brokers” or “sales reps”) to bring their products and services to market. These companies often invest just as heavily in their distributors, as if they were company employees. They provide the same type of confidential and proprietary information, and depend upon their distributors to develop and strengthen their customer relationships. Not surprisingly, many companies that utilize distributors include restrictive covenants in their distributorship agreements.

Despite this fairly widespread practice, there is very little case law or even academic discussion regarding the enforceability of restrictive covenants in distributorship agreements. The courts in most jurisdictions have never directly addressed the issue. Yet, some telltale themes have quickly developed in the few cases that have analyzed the issue, and companies who utilize distributors should be aware of these themes.

II. RESTRICTIVE COVENANTS – HIGHLY SCRUTINIZED

As a general rule, restrictive covenants are disfavored because they constrain competition in the marketplace and prevent individuals from working in their chosen fields of expertise. Courts therefore highly scrutinize restrictive covenants, and traditionally will enforce them in only two situations: (1) when the restrictive covenant is contained within an employment agreement, and (2) when the restrictive covenant is ancillary to the sale of a business.

The distinction is important because courts apply a stricter standard to employment agreements than they do to covenants ancillary to the sale of a business. The rationale behind the different standards is that “a purchaser in the sale of a business context holds more bargaining power than an ordinary employee in an employment context.” Thus, if a covenant not to compete is ancillary to the sale of a business, then the covenant must only be reasonable as to time, geographical area and the scope of the prohibited business activity. If the covenant is included in an employment agreement, however, the party seeking to enforce the restriction must show additional circumstances, “such as a near-permanent relationship with his employee’s customers and that, but for his association with the employer, the former employee would not have had contact with the customers, or the existence of customer lists, trade secrets or other confidential information.”

As explained below, the few jurisdictions that have analyzed restrictive covenants in the context of a distributorship agreement have tended to view them under the stricter, “employment” standard. Others have avoided the dichotomy by declining to enforce the covenants for other reasons, or simply enforced (or declined to enforce) them without analyzing the standards for enforceability.
III. Non-Competes and Non-Solicits

The *Stuntence, Inc. v. Gallagher Security (USA), Inc.*, case involved a covenant not to compete in a distributorship agreement. The [counter]defendant in that case was a distributor of non-lethal electric fencing that Gallagher Security manufactured, marketed and sold to correctional facilities. Pursuant to the parties’ distributorship agreement, the distributor could not “carry on, be engaged in or interested in, be concerned in, grant financial assistance to, or obtain or assist in obtaining financial assistance for, be interested whether as an employee, manager, proprietor, partner, shareholder, director, financier consultant or otherwise in any business undertaking associated with the products and systems relating to electric security fencing in competition with Gallagher…” for a period of one year following the termination of the agreement.

The manufacturer sought to enforce the restrictive covenant, and argued that it should be viewed under the more liberal, “sale of a business” standard. The court rejected this argument, and concluded that a restrictive covenant contained in a distributorship agreement should be viewed under the more stringent, “employment” standard. The court then analyzed the terms of the restrictive covenant, and concluded that it “purports to completely exclude [the distributor] from participating in any way in the security fencing business anywhere in the world for a year after the termination of the agreement.” The court concluded that the purpose of the covenant was to prevent competition *per se*, and it therefore refused to “blue-pencil” its scope in order to bring it within the realm of reasonableness.

The case of *Amstell, Inc. v. Bunge Corporation*, is similar. The plaintiff in *Amstell* had developed a “fiber base concentrate” to be used in the production of fiber-fortified milk, and had contracted with the defendant to manufacture and distribute the product. The parties entered into a manufacturing contract, which contained the following restrictive covenant:

During the term of this Agreement, or for a period of 3 years thereafter, [manufacturer/distributor] will not produce (or in any way assist or consult in the production of) for its own account or for others, any concentrates or finished products which are fiber-fortified milk concentrates.

The parties also entered into a nondisclosure agreement, which provided:

[Manufacturer/distributor] agrees and covenants that during the period [manufacturer/distributor] is supplying and producing fortified beverage products for [plaintiff] and for a period of three years after termination thereof for any reason whatsoever, [manufacturer/distributor] will not, directly or indirectly…anywhere engage in any enterprise which develops, produces, licenses, or makes fiber-based concentrates for the production of fiber-containing milks or dairy base concentrates for the production of fiber-containing shakes and ice cream.

The plaintiff sued to enforce the restrictive covenants, and argued that its manufacturing and nondisclosure agreements should be analyzed under the less stringent, “sale of a business” standard. The court rejected this argument because there was no sale of any assets, stock or goodwill between the parties. Instead, the terms of the arrangement “plainly make the covenants not to compete ancillary to an independent contractor manufacturing and distributorship agreement,” which the court treated as an employment agreement rather than a sales contract.

On the other hand, the *Arcor, Inc. v. Haas* case lends support for the proposition that a less stringent standard should be applied to distributorship agreements. In *Arcor*, the Illinois Appellate court was called upon to analyze the enforceability of a non-competition agreement contained in a shareholder agreement. The trial court evaluated the shareholder agreement under the more liberal, “sale of a business” standard. However, the trial court ultimately concluded that the restrictive covenant – which prohibited the shareholder from being involved in “any business or venture that sells products competitive to those of Arcor” – constituted a “blanket prohibition on competition,” and was therefore unreasonable and unenforceable. On review, the appellate court affirmed the trial court’s decision based only on the “blanket prohibition” issue; the appellate court did not address the standard (i.e., liberal or strict) under which a non-compete ancillary to a shareholder agreement should be viewed.

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Finally, the Pennsylvania appellate court in *Volunteer Fireman’s Insurance Services, Inc. v. CIGNA Property and Casualty Insurance Agency*, analyzed the enforceability of a non-compete covenant contained in a joint venture agreement between an insurance company and its sales agency, but avoided deciding which standard should apply.\(^2\) For its part, the trial court noted that Pennsylvania jurisprudence had enforced covenants not to compete in the two traditional contexts: (1) when contained in an employment agreement, and (2) when ancillary to the sale of a business.\(^3\) Although the restrictive covenant at issue did not fall within either of these categories, the trial court concluded that it was “satisfied that Pennsylvania law recognizes the relationship of joint venturers as a proper one to support an enforceable restrictive covenant.”\(^4\) The appellate court subsequently analyzed the issue under the Restatement of Contracts, which states in relevant part:

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(2) \text{Promises imposing restraints that are ancillary to a valid transaction or relationship include the following:}
\]

- * * *

\[
(c) \text{a promise by a partner not to compete with the partnership.}
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* * *

Comment (h): Promise by a Partner. A rule similar to that applicable to an employee or agent applies to a partner who makes a promise not to compete that is ancillary to the partnership agreement or an agreement by which he disposes of his partnership interest. The same is true of joint venturers, who are treated as partners in this respect.\(^5\)

The appellate court therefore concluded that a covenant not to compete between an insurance company and its sales agency would generally be recognized under Pennsylvania law – but it did not articulate which standard should be applied.\(^6\) However, the appellate court affirmed the trial court’s enforcement of the non-compete, because: (1) it was entered into by sophisticated parties, (2) it was ancillary to the main purpose of a lawful transaction, (3) it was necessary to protect a legitimate business interest, (4) it was supported by consideration, and (5) it was appropriately limited as to scope, time and territory.\(^7\)

**IV. Non-Disclosure Agreements and Trade Secrets**

In addition to non-competition and non-solicitation covenants, distributorship agreements may also contain non-disclosure covenants, which are designed to protect a company’s confidential and proprietary information. Regardless of whether the restrictive covenant is viewed under the more stringent “employment” standard, or the more liberal “sale of a business” standard, companies may be able to enforce a non-disclosure covenant through a “back door” trade secret misappropriation claim.

In order to sustain a claim for trade secret misappropriation under the Illinois Trade Secrets Act\(^8\) (the “Act”), a plaintiff must plead and prove: (1) the information at issue qualified as a “trade secret,” (2) the trade secret was misappropriated by the defendant, and (3) the defendant used the trade secret in its business.\(^9\) The Act defines a “trade secret” as follows:

Information, including but not limited to, technical or non-technical data, a formula, pattern, compilation, program, device, method, technique, drawing, process, financial data, or list of actual or potential customers or suppliers that:

(1) is sufficiently secret to derive economic value, actual or potential, from not being generally known to other persons who can obtain economic value from its disclosure or use; and

(2) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy or confidentiality.\(^10\)

It is a grave mistake to assume that documents or information will be protected simply because they are labeled “confidential” or are referred to as a “trade secret.” In order to qualify for protection under the Act, the documents or information must be valuable precisely because they are secret, and one must take concrete steps to protect and maintain their secrecy.\(^11\)

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Thus, for example, in *Liebert Corp. v. Mazur*, a plaintiff’s “confidential and proprietary” customer information was held not to be a trade secret because the plaintiff failed to take reasonable steps to keep the information confidential.\(^{32}\) The court found that although electronic copies of customer information were provided to employees on a need-to-know basis, no other steps were taken to restrict any physical copies of the information. There was no evidence that plaintiff advised its employees, verbally or in writing, that the information was confidential, and employees were not required to sign a confidentiality agreement.\(^{33}\)

Although a non-disclosure agreement is certainly an important factor to consider for trade secret protection, it is not the only factor. For example, in the *Arcor, Inc. v. Haas* case, the only security measure that the plaintiff took was to have its employees sign a non-disclosure agreement.\(^{34}\) Because “there was no evidence presented that Arcor did anything more than require its employees to sign a confidentiality agreement,” the Court declined to afford trade secret protection to the company’s customer lists.\(^{35}\) The court also noted that “[h]ad Arcor taken additional measures, such as limiting access to its customer information by computer password or keeping track of the hard copies of the information, we might hold otherwise.”\(^{36}\)

By way of contrast, the court in *Multiut Corp. v. Draiman*, found that the plaintiff’s customer information was a trade secret because the plaintiff took reasonable steps to safeguard its customer information by limiting access to both printed and computer-stored copies of the information and by requiring employees to sign confidentiality agreements.\(^{37}\) Similarly, in *Stampede Tool Warehouse, Inc. v. May*, the court found that the plaintiff’s customer information could be protected as a trade secret because of the numerous security measures the plaintiff undertook to protect the information.\(^{38}\) Specifically, the plaintiff kept its offices locked, checked the garbage daily, had special computer access codes for employees, limited customer information to persons on a need-to-know basis, kept hard copies of customer lists locked, kept salesmen’s call books and customer cards locked, had security cameras, and required employees to sign confidentiality agreements that stated that the names of plaintiff’s customers could not be used or disclosed because they belonged to plaintiff and were confidential.\(^{39}\)

V. Conclusion and Recommendations

When called upon to enforce a restrictive covenant ancillary to a distributorship agreement, it is more likely than not that a court will apply the more stringent, “employment” standard. However, a strong argument can be made for applying the more liberal, “sale of a business” standard. The rationale for using the more liberal standard is the degree of bargaining power between the parties. That is, a restrictive covenant ancillary to the sale of a business is more likely to be enforced because the party who sells its business (and finds itself subject to the restrictions) is generally more sophisticated and has significantly greater bargaining power than a typical employee.

But this rationale applies equally well to a distributor who is negotiating a distributorship agreement in an arms-length transaction. Presumably, both parties are equally sophisticated, and possess equal bargaining power. The distributor can easily negotiate the terms of the restrictive covenant and, for example, trade an increase in geographic scope in exchange for an increase in revenue; decrease the duration of the restriction in exchange for lower revenue or more relaxed performance standards; or any other calculus of terms. Thus, because a distributor can negotiate the terms of a distributorship agreement just as well as a seller can negotiate the sale of its business, there is no reason for courts to apply the more stringent, “employment” standard when called upon to enforce restrictive covenants in that context.\(^{40}\)

Regardless of the standard to be applied to the agreement, companies who use distributors should include restrictive covenants in their distributorship agreements. Indeed, it is essential to include – at a minimum – a non-disclosure covenant in order to protect its trade secrets. Companies should take the following steps in order to maximize the likelihood that their restrictive covenants will be enforced:

- First, the company should not use “boilerplate” restrictive covenants, but rather should negotiate the terms of the proposed restrictions with its distributor. The company should conduct these negotiations at arms-length to ensure equality in bargaining power. This will mitigate in favor of a court using the more liberal, “sale of a business” standard when (if) it comes time to enforce the covenant. Moreover, in order to demonstrate the equality of bargaining power, it will be important for the company to save all documents relevant to the negotiation (e.g., draft agreements, e-mail correspondence, notes, etc.).

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Second, the scope of the restrictive covenant should be as narrow as possible. The covenant should only proscribe activities that: (a) the distributor provided to the company, and (b) are directly relevant to, and have an economic impact upon, the company’s business.

Third, the geographic limitation of the restrictive covenant should be as narrow as possible. National or international (or even statewide) restrictions are unlikely to be enforced. Instead, the geographic reach of the restriction should extend no farther than necessary, and should be limited to the geographic area in which the distributor actually provided service to the company.

Fourth, the restrictive covenant should be of limited duration. While there are no hard-and-fast rules, a restrictive covenant greater than two years is unlikely to be enforced. A restrictive covenant of 12 months or less is more likely to be enforced.

Finally, in addition to including a non-disclosure covenant in the distributorship agreement, the company should take all available steps to protect its proprietary and trade secret information.

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(Footnotes)
1  Sheehy v. Sheehy, 702 N.e.2d 200 (Ill. App. 1st Dist. 1998).
4  Arcor, 842 N.E.2d at 273.
5  Id.
6  See, e.g., All Line, Inc. v. Rabar Corp., 919 F.2d 475 (7th Cir. 1990) (enforcing restrictive covenant in distributorship agreement, but limiting damages on other grounds); Durapin, Inc., v. American Products, Inc., 559 A.2d 1051 (S. Ct. R.I., 1989) (declining to enforce restrictive covenant in distributorship agreement on trade secret grounds). See also, Water Processing Technologies, Inc. v. Ridgeway, 618 So.2e 533 (Ct. App. La. 1993) (concluding without analysis that covenant not to compete in distributorship agreement was an “employment relationship”).
7  2002 WL 1838128 (N.D. Ill. 2002).
8  2002 WL 1838128 at *7.
9  Id. at *6.
10 Id. Specifically, the court concluded that “we disagree with Gallagher that this situation is more analogous to the purchase of a business than an employer-employee relationship; the distribution arrangement between the parties strongly resembles that between a salesperson who operates in a specific geographic area for his or her employer.” Id.
11 Id. at *7.
12 Id.
14 443 S.E.2d at 706-07.
15 443 S.E.2d at 707.
16 Id.
17 Id.
18 842 N.E.2d at 618.
Illinois courts define a “blanket prohibition” as prohibiting all competition within a particular geographical area. *Id. See also, Eichmann v. National Hospital & Health Care Services, Inc.*, 719 N.E.2d 1141 (Ill. App. 1st Dist. 1999). An “activity restraint,” on the other hand, merely limits the types of activities in which a person can engage. *Id.* As a general rule, activity restraints can be reasonable, whereas blanket prohibitions are almost always unreasonable. *Id.* Although Illinois law does allow a court to modify, or “blue pencil,” a restrictive covenant in order to narrow its scope and render it enforceable, “a court should refuse to modify an unreasonable restrictive covenant, not merely because it is unreasonable, but where the degree of unreasonableness renders it unfair.” *Id.*

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21 *Id.*


23 693 A.2d at 1336. When reviewing the enforceability of restrictive covenants, Pennsylvania courts have placed primary focus on whether the restraint (covenant) is ancillary to the main purpose of the agreement, rather than on the nature of the relationship between the parties. “The controlling question this is stated, whether the promise has a protectable interest such that a reasonable covenant not to compete, effective upon termination of the agreement, would be enforceable against the promisor.” Thus, the fact that a restrictive covenant does not fall neatly into a particular category does not render it per se unenforceable under Pennsylvania law. To the contrary, “[i]t is only where the sole object of both parties in making the contract is to restrain trade or control prices that the covenant will be declared void.” 693 A.2d at 1336 (fn 7).

24 693 A.2d at 1336.

25 693 A.2d at 1337, citing Restatement (Second) of Contracts, § 188(2).

26 693 A.2d at 1337.

27 *Id.*

28 Note that the Illinois Trade Secrets Act, 765 ILCS 1065/1 et seq., is a “uniform” act, and its language is therefore virtually identical in every State that has adopted the Act.


30 765 ILCS 1065/2(d).

31 When called upon to apply the Act, Illinois courts also consider six common law factors to determine whether a trade secret exists: (1) the extent to which the information is known outside of the business; (2) the extent to which the information is known by employees, agents and others involved in the business; (3) the extent of the measures taken to guard the secrecy of the information; (4) the value of the information; (5) the amount of effort or money expended in developing the information; and (6) the ease or difficulty with which the information could be properly acquired or duplicated by others. *Delta Medical Systems v. Mid-America Medical Systems, Inc.*, 772 N.E.2d 768 (Ill. App. 1st Dist. 2002).


33 *Id.*

34 842 N.E.2d at 270 (Ill. App. 1st Dist. 2005).

35 *Id.*

36 *Id.*


39 *Id.*

40 By focusing on the details of the transaction – i.e., whether there was a transfer of assets, stock or goodwill – the *Amstell* court exalted form over substance. A court can (and should) apply the “sale of a business” standard to a distributorship agreement, even if there has not been an actual sale of a business.