

# CREATING ENFORCEABLE NONCOMPETE AGREEMENTS WITH BANK OFFICERS AND OTHER KEY EMPLOYEES

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*In this article, the authors discuss noncompete agreements in the context of federal banking law. These agreements can provide a bank much needed protection against harmful competition from a separated officer. However, the authors caution, a noncompete agreement tied to a severance package requires special care to ensure enforceability.*

**B**anks, like many employers, rely on employees to develop proprietary processes and special relationships with customers in order to develop their businesses. Those employees can come into contact with trade secrets and proprietary information that is extremely valuable to the bank and not otherwise publicly available. They can also come into contact with customers in such a way as to develop a “personal hold” on the goodwill of the bank.

## PROTECTING PROPRIETARY INFORMATION

So, how does a bank protect its goodwill and confidential information in the event an employee leaves? The natural answer is a noncompete agree-

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ment with employees who have proprietary information and/or special customer relationships. If the employee leaves the bank, he or she cannot work at a competing bank for a designated period of time. The noncompete period enables the bank to train new employees or transfer customer loyalty to other employees free from competition from the separated employee.

## **POST-TERMINATION NONCOMPETE AGREEMENTS**

Sounds simple, right? Wrong. Requiring an employee not to compete while he or she is working for the business is par for the course, but holding the employee to the same standard *after* he or she has left the bank is another story. Post-termination noncompetes are disfavored in Minnesota and elsewhere because they negatively affect individuals' abilities to support themselves and maintain their livelihood. Of course, the post-termination noncompete must be in place before the employee leaves his or her job. In order to create a valid and enforceable post-termination noncompete, employers (including banks) generally must clear three hurdles. First, employers must show that the noncompete is supported by adequate consideration. Second, employers must show that the noncompete does not impose overly broad geographic or time constraints on the employee's ability to find suitable work after leaving the company. Finally, employers must establish that the noncompete is needed to preserve a legitimate employer interest.

### **What Is the Best Timing and Consideration for a Noncompete Agreement?**

Typically, the consideration is the actual offer of employment. However, timing is key. If an employee already has accepted the job offer or started work before signing a noncompete, then, depending on applicable state law, it may not be supported by adequate consideration. Instead, the bank must pay independent consideration in return for the noncompete. Most employers who want noncompetes from current employees will therefore condition a promotion, raise, or new bonus on the employee's signing the noncompete. In other words, they put something new on the table, something of value

that otherwise would not have been available to the employee, in return for the employee's agreement not to compete.

### **Is the Noncompete Agreement Overbroad?**

When deciding how broad the noncompete should be, and how long it should last, differently-situated employers will come to different conclusions. Considerations include where the bank's clients are located, the nature of the employee's job duties, how reliant the bank is upon the particular employee to develop and/or preserve business relationships with customers, the nature of the trade secret or confidential information, how long it would take to transfer customer loyalty to different employees, and how long it will take to train the employee's replacement. Because these and other factors will vary from bank to bank and industry to industry, there is no blanket "accepted" time or geographic limit on noncompetes. That said, when deciding on the scope and duration of a noncompete, most jobs would not justify a nationwide noncompete or a noncompete in excess of a year or two.

### **What Constitutes Legitimate Employer Interests?**

With regard to legitimate employer interests, employers must establish that they are not seeking the noncompete as a matter of rote, i.e., asking for a noncompete from every employee regardless of whether it is needed to protect a legitimate business interest. Employers also cannot impose noncompete requirements on employees for purely punitive or anticompetitive reasons. Legitimate interests include protecting the bank's goodwill (including the goodwill of its customers), trade secrets, or confidential information (i.e., information that gives the bank a competitive advantage).

## **THE BANK ACTS**

In the case of banks, three Bank Acts — the National Bank Act, the Federal Reserve Act and the Federal Home Loan Bank Act (collectively, "the Bank Acts") — add another layer of complexity to the enforceability of noncompete agreements for bank officers.

## Termination Power

The Bank Acts give banks protection from state law breach of contract and tort (but not discrimination) claims arising from an allegedly wrongful termination of a bank officer. The Bank Acts do this by providing that a bank's board has the power to appoint a "president, vice president, cashier and other officers" and the power to "dismiss such officers...at pleasure." The Bank Acts ensure the bank board's statutory right to terminate officers "at pleasure" despite contractual provisions or bank personnel policies to the contrary. The historical reason for the bank board's termination power is to ensure the safety and prosperity of the banking industry and preserve public confidence in the bank. If an officer's integrity is questioned, whether justified or not, the board must possess the ability to terminate the officer regardless of what his or her employment contract or a bank discipline policy might say.

These Bank Act provisions have interesting and esoteric implications for the manner in which terminations are carried out, and for the enforcement of employment noncompetes in some situations. For example, the Bank Acts provide that a bank's right to terminate "at pleasure" applies only to bank officers. "Officers" are those individuals who hold positions created by the bank's board of directors and identified as officers in the bank's bylaws. "Officers" must be appointed by the board, either directly or through delegation of authority, and must have express authority to bind the bank by executing contracts or other legal instruments on the bank's behalf. Finally, "officers" must possess decision-making authority relating to fundamental banking operations so as potentially to affect the public's trust in the bank.

To invoke the protection of the at-pleasure termination provision of the Bank Acts, a bank's board of directors must hire and fire the officer. If instead a bank officer is fired by a more senior bank officer, the terminated officer's right to bring a wrongful termination claim against the bank will not be preempted by the Bank Acts. The board must ratify the officer's termination by action recorded in minutes of the board for the at-pleasure provision to apply.

The "public confidence" aspect of the Bank Acts, which justifies giving bank boards broad discretion to terminate bank officers without fear of state

law breach of contract or tort claims, introduces an element of uncertainty about the enforceability of a noncompete in some situations. For example, when employers act to enforce noncompetes, courts will consider the likelihood of the bank being able to show it had the right to terminate the employee in the manner it did. Courts will evaluate the balance of equities and whether the employer has “clean hands” — whether the employer acted unconscionably or by reason of a bad motive.

### **Severance Pay and the Noncompete Agreement**

Another element of uncertainty that the Bank Acts create arises in the situation where a bank ties severance pay to an employee’s noncompete agreement. In nonbanking industries, employers may create this severance/noncompete tie-in as a way to preemptively shut the door on an employee claiming that his or her noncompete is unenforceable for lack of consideration or because it is too long or covers too much territory. In the case of banks and their officers, however, the practice of tying a noncompete to severance pay raises enforcement implications.

### **The Enforceability Dilemma**

The enforceability dilemma occurs because, prior to the mid-1990s, courts interpreted the “at pleasure” requirement of the Bank Acts to bar both the former officer’s state law breach of contract and tort claims (as discussed above) and any claim against the bank for payment of severance, even though severance was contractually promised. If the severance was the only consideration for the noncompete, the enforceability of the noncompete also was brought into question.

However, since 1996, courts have not taken such a restrictive view of the enforceability of an obligation to pay severance contained in an officer’s employment agreement. Relying on regulations which allow banks to enter into employment agreements with officers upon reasonable terms and conditions, courts have enforced severance obligations when the bank has used a severance package as a negotiating tool to recruit an officer. In other words, a bank’s statutory right to terminate an officer at-pleasure and the

bank's contractual obligation to pay severance following the termination are not mutually exclusive. Under this same logic, even though state law breach of contract and tort claims are precluded following an "at pleasure" officer termination, the bank most likely will be required to pay the severance it promised the officer in the employment agreement in exchange for the post-termination noncompete, and the officer will be required to comply with the noncompete's restrictions if otherwise enforceable.

Still, the recent trend of enforcing contractual severance obligations when tied to a noncompete is not absolute. One strategy for banks to use to avoid the severance/noncompete enforceability dilemma is not to rely on severance packages to support noncompete agreements. In other words, simply provide other adequate consideration, as provided by applicable state law, in exchange for an officer signing a noncompete. Alternatively, banks may wish to try to structure severance and noncompete agreements at the holding company level.

## **CONCLUSION**

A noncompete that satisfies all applicable enforceability requirements can provide a bank much needed protection against harmful competition from a separated officer. However, drafting a bank officer's noncompete tied to a severance package requires special care to ensure enforceability.