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the LEGAL UPDATE

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Labor and Employment Update

The Puerto Rico Supreme Court Revisits Terms of Non-Compete Agreements

Puerto Rico's Supreme Court is generally cautious of contracts that restrict a person's constitutional right to work in the occupation of his or her choice and the public's right to choose who to engage with in business. Accordingly, it has placed limitations on covenants not to compete in the employment and franchise contexts. Recently, it addressed these restrictions in the context of stock purchases, making a slight indication towards greater openness on the subject.

In Arthur Young Co. v. Vega III, 136 D.P.R. 157 (1994), the Supreme Court held that non-compete agreements in the employment context must strictly comply with certain requirements or face nullification, to wit: (1) the agreement must specify the restrictions on competition in terms of geographical areas or clientele; (2) sufficient consideration must be provided to the employee; (3) the scope of the prohibition must match the employer's legitimate interests; and (4) the restrictions must not exceed *twelve months*.

Years later, in Martin's BBQ v. García de Gracia, 178 D.P.R. 978 (2010), the court considered the validity of a covenant not to compete within a franchise agreement. Thus, it concluded that the weaker party should be protected. It held that a two-year restriction was not reasonable.

Until Ramis CPA, Group v. Serra Torres, 2016 T.S.P.R. 126 (2016), however, the court had not addressed how to evaluate covenants not to compete in the context of a stock purchase agreement. The agreement in that case implemented the termination of services rendered by an accountant to a professional services corporation of which she was a shareholder. She received a payment of $150,000 to purchase her shares. In exchange, she terminated services to the corporation and agreed not to provide services to its clientele for a term of *sixteen months*. The corporation sued the accountant after it found out she had provided services to at least six of its clients. The trial and appeals courts held that the sixteen-month term failed the Arthur Young Co. validity test. Through a non-binding decision, a plurality of the Supreme Court disagreed that said test was applicable, because the restrictions did not arise in the employment context. In his concurring opinion, Judge Kolthoff Caraballo noted that, because the agreement not to compete was part of a stock purchase agreement, and not in an employment context, the parties had similar negotiating power. Due to their similar positions, he indicated that the covenant not to compete would be evaluated to determine if it was reasonable. He then reviewed stateside case law which, in similar

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situations, had allowed periods of non-competition between two and five years. He concluded that the sixteen-month term was a reasonable protection to the corporation's interest.

Significantly, Ramis CPA, Group v. Serra Torres is a judgment, not an opinion. This means that it is not binding precedent for future cases. Nonetheless, as Judge Kolthoff Caraballo's opinion was supported by three other judges of the Supreme Court, it suggests that the standard of Arthur Young will be more flexibly applied outside the employment relationship. In the context of stock and asset purchase agreements, where the prior owner is often bought-out and held not to compete, the decision in Ramis CPA, Group v. Serra Torres will help stop the guess-work as to the permissible scope of said restrictions.

Our team of lawyers at Reichard & Escalera is available to provide assistance on how to implement and evaluate agreements not to compete.

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