

Restrictive Covenants And Other Techniques To Protect Customer Relationships

Courts frown on broad restrictions on future employment but may uphold properly drafted, less onerous prohibitions

14

Michael C. Lasky and Jessica Golden Cortes

In our information-driven, service-economy society, employers are constantly searching for new ways to remain at, or be propelled to, the forefront of their respective industries. A core ingredient in achieving this goal is to continuously build a loyal customer base. To do so, employers must attract and retain key employees, who are responsible for building and nurturing these fundamental customer relationships. But how can an employer adequately protect its relationships with customers when key employees inevitably leave the company.

Over the past few years, it has become increasingly important to understand the wide range of pre-existing and new methods available to help employers protect and preserve their customer base when key employees leave their organization. This chapter examines the following:

- 1) the numerous alternatives available to forward-thinking employers;
- 2) how employers can develop and implement appropriate policies, and challenges they face;
- 3) remedies available to employers that believe a former employee has violated his or her post-employment obligations; and
- 4) how to minimize the risk of exposing employers to a lawsuit by learning ahead of time whether prospective new hires are subject to post-employment obligations to their *former* employers.

Bear in mind that there is no federal law that governs this subject. Rather, this area is governed entirely by state law – predominantly court decisions (although some states,

Michael C. Lasky is the co-chair of the Litigation Department and a member of the Management Committee of Davis & Gilbert, LLP, a New York City law firm that advises clients in all industries and throughout the country in connection with drafting, implementing and enforcing post-employment restrictions. He can be reached at mlasky@dglaw.com. Jessica Golden Cortes, an employment law associate at the firm, can be reached at jcortes@dglaw.com.

such as California, Georgia, Louisiana and Texas, have also enacted relevant statutes in addition to having a body of cases interpreting those statutes). This chapter is not intended to be a substitute for legal advice tailored to an employer's specific industry and objectives, and the individual circumstances of a particular employment situation. Nor is it intended to be exhaustive survey of the court decisions in the area of restrictive covenant law in each of the 50 states. For such a detailed, state-specific text, we recommend reviewing *Covenants Not to Compete: A State-by-State Survey*, by Brian M. Malsberger (American Bar Association, 2007 Ed.). State-by-state surveys, however, typically do not provide a framework for a business or human resources (HR) executive to understand or evaluate the pros and cons of various post-employment techniques.

This chapter is thus designed to provide a framework that allows management to collaborate with in-house and/or outside legal counsel to shape a company policy that is both consistent with the goals of the company and the law in the specific state under consideration.

The 'Tool Kit'

To determine which restrictive covenant techniques are best-suited to implement at your company, it is first essential to be aware of the different available techniques. In reviewing the definitions and examples that follow, it is important to understand that courts generally disfavor restrictive covenant agreements and make every effort to protect an employee's freedom of employment and freedom to earn a living. Courts carefully weigh this strong interest of the employee against the company's stated reason for attempting to enforce a restrictive covenant against the particular employee.

In general, to be enforceable, the court must find that a restrictive covenant is both reasonable in its restriction and necessary to protect the employer's legitimate business interests. Most often, these "legitimate interests" of the company are trade secrets, confidential information or other protectable assets. Courts in some states also recognize the protection of a customer relationship — especially a longstanding customer relationship — to be a legitimate interest of the company.

The 'Tools'

There are at least four separate types of post-employment restrictions or "tools" for a company to consider:

- 1) Non-Competition Agreements;
- 2) Customer-Based Restrictive Covenants;
- 3) Employee Non-Raid Provisions; and
- 4) Extended Notice Provisions and Garden Leave.

Employers should separately consider implementing these tools with various levels of employees.

Non-Competition Agreements

Generally, a non-competition provision requires that the employee will refrain from working in the employer's industry for a fixed period of time after his or her

employment with the company ends. In other words, for a fixed post-employment period, the employee agrees not to work for, or to be affiliated with, any business that would in any way compete with the former employer, or to perform the same type of work that the former employer performs. It is the most restrictive form of post-employment obligation because this type of provision prevents an employee from working or earning a living in the industry of his or her chosen profession for a period of time. Accordingly, it is the most difficult for an employer to enforce in court.

Given the stringent nature of this type of restriction, it is especially important to evaluate what the company is providing to the employee in exchange for the non-compete. Is it merely either the company's initial offer of employment or the company's offer of continued employment? In many states, those commitments would not be deemed to be sufficient consideration for the non-competition agreement to be enforced. However, the agreement will have a higher likelihood of enforceability where an employer provides a significant financial benefit to the employee — whether by way of a bonus, stock interest or a continuation of the employee's base salary during the term of the non-compete.

Sample Non-competition Provision:

Employee acknowledges and agrees s/he has (a) had access to the confidential, proprietary, sensitive and/or privileged information of the company and its clients and customer information to which s/he has or will be exposed and entrusted; (b) unique knowledge of Employer's business operations, plans, strategies, and client and customer needs and relationships. Employee further acknowledges and agrees that the Employer would be irreparably harmed if this information was used or disclosed for the benefit of anyone other than the company.

Accordingly, for a period of ____ from the date of termination of employment with Employer, Employee will not engage in, participate in, or become involved in any business, trade, activity, conduct or employment for or with, work or consult for or with, be employed by, or have any association or relationship with, any of the employers, organizations, firms, businesses, enterprises, entities or other persons that conduct, operate, or engage in any business, trade, activity, enterprise or conduct engaged in by Employer.

Customer-Based Restrictive Covenants

Customer-based post-employment restrictions are a less onerous form of restriction for a departing employee than a non-competition provision. For that reason, they are more likely to be enforceable than a non-competition provision. A customer-based restrictive covenant requires that for a specific period of time after the employee departs from the employer, the employee will not work for, or try to obtain business from, customers of the former employer.

This obligation is less restrictive than a non-competition agreement because it does not prohibit the employee from working in the industry as a whole, or from working for a competitor. Instead, it *only* prevents the executive from performing competing services for particular *customer entities* for a specific period of time. A typical customer-based restrictive covenant will also prohibit the employee from assisting a new employer in trying to secure business from the former employer's customers.

Here is typical customer-based post-employment restrictive covenant provision

Employee agrees that in the event that Employee's employment with Employer is terminated for any reason, for a period of ____ after the termination of Employee's employment, Employee shall not:

- (a) solicit any customers of Employer who were customers of Employer at any time during the ____ year[s] immediately before Employee's termination; or potential customers of Employer who Employer sought business from within ____ months of Employee's termination;
- (b) render to or for any customer of Employer any services of the type rendered by the Company; or
- (c) request or influence any of Employer's customers or suppliers to lessen the amount of business conducted with Employer, or to discontinue doing business with Employer.

Employee Non-Raid Provisions

Non-raid provisions require that for a fixed period of time after an employee departs from an employer, the departing executive may not solicit or encourage remaining employees of the former employer to leave the company.

Sample Non-raid Provision

Employee agrees that in the event that Employee's employment with Employer is terminated, for any reason, for a period of ____ after the termination of Employee's employment, Employee shall not employ or attempt to employ or assist any other person or entity in employing any employee or contractor of Employer, or otherwise induce said employees or contractors of Employer to terminate their employment or engagement with Employer.

Extended Notice Provisions and Garden Leave

A "notice" provision requires a departing employee to give the company a certain period of advance notice when he or she intends to leave the company. These provisions may also be drafted to provide several other benefits to the company, especially when dealing with key employees. First, extended notice provisions may require the employee to notify the company of offers received from competitors or other prospective employers. Second, these provisions may also require that the employee advise any prospective employer of continuing post-employment obligations he or she has to the current employer. In exchange, an employer may also agree to provide reciprocal notice in the event that the company decides to terminate the employee.

An employer that elects to use "notice" provisions may well require senior-level employees and executives to give significantly more notice than junior-level employees, because of their strong customer relationships and substantial access to the company's confidential and proprietary information. In determining the appropriate amount of notice to require of a particular group or "tier" of employees, employers should consider such items as: 1) the relative disruption that the employee's departure could cause to the company's business with particular customers with whom that employee has a relationship; and 2) how much time the company might need to find and train a suitable replacement for that employee.

The “notice period” is the period of time between when the employee notifies the company of his or her pending departure, and the employee’s actual termination date. A “garden leave” provision effectively prevents the employee from competing with the employer during the “notice period.” In return, employers typically continue to pay the employee’s base salary, and benefits. To increase the likelihood of enforceability of a “garden leave” provision, employers may consider offering employees a choice regarding the duration of the “notice period.” For example, an employer may offer an employee “notice period” options of three months, six months or one year, in exchange for continuation of payment of the employee’s base salary during that time. Arguably, a court is more likely to uphold a “garden leave” provision as reasonable and enforceable where the *employee* has chosen the length of time that he or she will be bound by its restrictions, especially because the employer will continue to pay the employee’s base salary during this time.

“Garden leave” provisions may also dictate specific requirements of the employee during the “notice period,” to the benefit of the company. For example, a “garden leave” provision often requires that an employee must assist in transitioning his or her work during the “notice period.” The provision may even require that the employee not come in to the office at all during the “notice period.” In fact, the concept of garden leave first became popular in England, and the name “garden leave” derives from the concept that the key employee was sent home to “tend to his garden.”

The fundamental benefits of the “garden leave” provision, are that the employee may *not* perform services for any other employer during this time because the employee is still employed by the company. Furthermore, the employee on “garden leave” typically cannot engage in any activities that compete with the employer, such as soliciting business from the employer’s customers, or soliciting the company’s employees. Thus, a “garden leave” provision affords the company all of these protections in exchange for continued payment of the employee’s base salary and benefits.

“Garden leave” provisions are most often implemented in agreements with senior-level executives or employees who have substantial relationships with the company’s customers, or have had substantial access to the company’s confidential and proprietary information. Given the obvious costs involved – the company is continuing to pay full salary and benefits to an employee who may not be working full-time, or at all, during the notice period – a cost-benefit analysis would likely prevent a company from implementing such provisions more widely among its employees. Moreover, it might be tenuous at best to seek to enforce such provisions against junior-level employees who have not had significant access to the company’s confidential and proprietary information, or who are not responsible for customer relationships. However, all situations need to be assessed on a case-by-case basis.

Here is a representative “garden leave” provision:

[Employer agrees that it will give Employee written notice of ____ weeks/ months before termination of Employee’s employment for any reason other than termination for cause or disability.] Employee [likewise] agrees that it will give Employer written notice of ____ weeks/months before voluntarily terminating Employee’s employment.

During the notice period, Employee will continue to be an employee, will assist Employer in the transition of your responsibilities and will be entitled to continue receiving base salary but not any other compensation that accrues or becomes

payable during such period, and to participate in all benefit plans for which Employee is eligible.

Employer may require that Employee does not come in to work during the notice period. In no event, however, may Employee perform services for any other employer during the notice period. Employer may, at its sole discretion, shorten the duration of the required notice period, provided that, in lieu of notice required to be given by Employer to Employee, it makes a severance payment to Employee equal to the amount of compensation Employee otherwise would have earned during the notice period had it not been shortened.

Often, a “garden leave” provision will also reiterate the non-competition, customer non-solicitation and non-service, and employee non-raid obligations, as discussed above.

Developing the Correct Matrix

It may be in the company’s best interest to implement multiple post-employment restrictions with regard to a particular category of employees. We call this process “layering.” Layering is especially beneficial to implement with senior-level employees and executives, because the more senior the employee, the more protection the company is likely to need when that employee departs.

For example, a forward-thinking company might implement a *six-month* extended notice provision for its senior executives, along with a garden leave provision to govern the employee’s conduct during that time. *In addition*, the company could then introduce a *six-month* non-compete provision and *one-year* customer non-solicitation and employee non-raid provisions, governing the executive’s post-employment obligations to the company. By combining several of the tools from the post-employment “tool-kit,” this matrix would, in effect, afford the company protection from competition by that executive for *one year* from the date he or she gave notice of resignation – ample time for the company to hire and train a replacement executive, to reinforce its relationships with the customers with whom the departing executive dealt, and to protect its legitimate business interests. It would also afford the company *a full 18 months* of protection against customer and employee solicitation by the departing executive.

Layering also has other benefits to the company. Specifically, implementing a matrix of multiple techniques allows the company to hedge its bets against a court refusing to enforce the most onerous of the restrictions (the non-compete), while still enjoying the protection of notice and garden leave provisions. A more complete example of a useful way to layer multiple restrictive covenant techniques is set forth in Exhibit A to this chapter.

Choosing the Most Effective Post-Employment Techniques for Your Company

Avoiding Common Drafting Problems

Beware of Overly-Broad Restrictive Covenant Provisions

Adopting broad, far-reaching non-competition, non-solicitation, non-raid and notice and garden leave provisions company-wide may be tempting. It may also be tempting

to impose these restrictions on employees for a significant period of time after the employees stop working at your company. Resist these urges. It would be a serious and costly mistake to implement any provisions that are broader than necessary to protect your company.

It is true that courts recognize the importance of protecting a company's legitimate business interests. However, courts also place paramount importance on protecting the employee's freedom to earn a living in his or her chosen profession. Therefore, courts in virtually every state seek to construe post-employment restrictions on employees *as narrowly as possible*. Courts in some states will revise or "blue pencil" restrictive covenant provisions deemed overly broad and enforce a narrower version of the provision. Yet, courts in many states are unwilling to rewrite an overly broad restrictive covenant provision and instead will, in essence, throw the proverbial baby out with the bath water: the court will declare the entire provision unenforceable. This, of course, would leave the company without any protection at all when an employee departs. For this reason, a company should not try to implement overly broad post-employment restrictions, which, more likely than not, will not withstand judicial scrutiny.

Increase the Likelihood of Enforceability

Depending on the industry in which your company does business, there are various ways to tailor a restrictive covenant provision to both meet the needs of your company and increase the likelihood of enforceability. The more narrowly-tailored a restriction is, the more likely it is to be enforceable.

For example, it will be more difficult to enforce a customer non-solicitation and non-service provision that prohibits the employee from soliciting or providing services to any customer in the industry if your company is part of a service industry in which you and your competitors all work with the same customers. Such a provision would effectively preclude the employee from working in the industry, which the courts would disfavor.

If, however, the provision were limited only to those customers *with whom the employee had worked or to whom the employee had pitched business* during the last year of employment, a court would be more likely to uphold such a provision. Why? Courts are more likely to reason that this type of provision is sufficiently tailored to meet the company's legitimate business interests, while not being overly restrictive of the employee's freedom.

Similarly, in a non-competition provision, employers should consider carefully how to define the "industry" in which the executive is prevented from working. Is the industry definition limited to a specialized area within a broader industry (for example, electronic asset management) or a broadly defined industry (for example, the entire financial services industry). The more broadly a company defines the "industry," the more difficult it will be for an employer to convince a court to enforce the non-competition provision. Therefore, to maximize the likelihood of enforceability, a company should favor a narrowly-defined definition of the term, which would still allow the employee to be gainfully employed in his or her chosen profession.

Additionally, while an employer may not necessarily require an industry-wide non-competition provision to protect its interests, it may seek to enforce a non-compete within only a *specific geographic area*, or, to impose a *product-specific* non-compete.

For example, if your company is an advertising agency and the departing employee worked on the Coca-Cola account at your company, to best protect its customer relationship, the employer may seek to implement a non-compete that prohibits the departing employee from working on a competitive beverage account at another agency or company, such as an account for Pepsi Cola.

To maximize the likelihood of enforceability, a company should also make sure to include a time-limitation on any restriction it seeks to impose. Enforceable restrictive covenant provisions typically contain time limits of six months to two years.

When and How to Implement/Roll-Out New Provisions

Although courts in different states vary somewhat on this issue, it is generally the case that an offer of employment acts as sufficient consideration for an employee to enter into a restrictive covenant agreement. Often, however, employers seek to impose restrictive covenant provisions after employees have already commenced working. In some states, an employee's continued employment for a period of time after signing the agreement acts as sufficient consideration for entering into that agreement. However, an employer should tie the new agreement to a particular bonus, promotion or raise in order to increase the likelihood of enforcement.

The manner in which new restrictive covenant provisions are introduced to current employees also potentially has great impact. It is extremely useful for a company to explain to current employees that these provisions should not be thought of merely as a restraint on *their* future employment. To the contrary, an employer should articulate clearly to its employees that a key benefit of implementing these provisions is to *protect* loyal employees and allow them to flourish. Unfortunately, employers frequently overlook the importance of delivering this type of positive message to their employees.

To elaborate, when these provisions are in place, if a key employee departs from the company, the remaining employees are afforded an increased level of job security, because the departing employee cannot compete with or solicit the company's customers for a specific period of time. Remaining, loyal employees thus have the opportunity to develop a closer relationship with those customers and help the company to retain their business. These provisions, therefore, serve as a method of job-protection for loyal employees, because if the company were to lose significant business stemming from competition by a departing employee, the company would be required to make corresponding reductions in its workforce.

When employers overlook this important issue, it makes the implementation of a new restrictive covenant seem to be an "employer v. employee" problem. When communicated in its proper context, however, loyal employees will understand the benefits the restrictive covenants have to both the non-departing employees and to the employer for which they continue to work.

There are some practical points to consider in disseminating restrictive covenant agreements to new and current employees. A trusted HR representative or executive must be responsible for three things: 1) making sure that employees execute the agreements; 2) collecting the signed agreements; and 3) maintaining the agreements in a secure and organized way. The agreements have little value to the company if they cannot be located at crucial times. To avoid this risk, some employers have instituted electronic means for their employees to execute of restrictive covenant agreements.

What Happens If an Employee Refuses to Sign an Agreement

In the event that an employee refuses to sign a restrictive covenant agreement, the company should immediately discuss the issue with legal counsel. In the vast majority of states, the company could, if it wished, withhold a promotion or bonus, or even terminate an employee for refusing to sign a restrictive covenant agreement. A California court, however, allowed a lawsuit to go forward based upon a claim that an employee-at-will was fired for refusing to sign a restrictive covenant agreement.

Remedies Available to a Company When a Former Employee Violates a Restrictive Covenant

Employers often assume that their remedy is to sue the former employee when they believe that a former employee has violated a restrictive covenant obligation. Here again, these issues must be reviewed with legal counsel on a case-by-case basis and may depend on the seniority of the employee, whether or not the employee has an employment contract and a host of other factors. Sometimes, employers also sue the former employee's new employer for an injunction and/or money damages. Many times, these types of lawsuits are the preferred remedy. An injunction will stop the violation from continuing and sends an important message to existing employees that the company will enforce its policies and challenge any violations of them.

However, there are potential downsides to lawsuits seeking injunctive relief. First, lawsuits are expensive, time-consuming, and may require the company's remaining employees to expend significant time and effort related to the suit. Second, lawsuits may jeopardize customer relationships. Third, lawsuits seeking injunctions often are not successful, particularly because injunction actions must be carried out on an expedited basis, before there is a complete opportunity to obtain deposition testimony or to recover or review documents from the files of the former employee.

It is therefore crucial to consider alternative remedies, which can be *built into* restrictive covenant agreements *before* the departure of the key employee. These alternatives include liquidated damages provisions and clauses requiring forfeiture of pre-existing benefits. In many cases, these remedies can sufficiently protect the company's interests and significantly diminish the likelihood that a lawsuit will be necessary.

Liquidated Damages Provisions

The basic premise of a liquidated damages clause in a restrictive covenant agreement is that the departing employee has to compensate his or her former employer for a pre-determined amount of damages if the departing employee violates any of the post-employment restrictions that are in effect.

A court will enforce a liquidated damages provision if it provides a formula for calculating a reasonable measure of anticipated damages. However, courts will not enforce the provision if the court construes the provision to be a penalty, rather than a provision of compensation based on a reasonable assessment of anticipated harm.

In determining what constitutes a "reasonable" measure of anticipated damages, courts will consider what damages were reasonably anticipated *at the time the agreement was entered into*. Depending on a company's needs, a liquidated damages provision could provide for payment of damages on a "sliding scale," based on the length

of the particular customer relationship at issue, or the revenue the former employee generated for the company. The provision should also state that the measure of such damages is uncertain, and not readily determinable. This is because it is impossible, at the time an agreement is entered into, to project, for example, how long a given customer would have remained with the company had the former employee not offered competing services or solicited its business.

The benefit of including a liquidated damages provision in a restrictive covenant agreement is three-fold: certainty, certainty and certainty. Without it, an employer seeking damages for a violation of a restrictive covenant will have to show that:

- 1) the covenant is valid and enforceable;
- 2) the former employee violated the restrictive covenant;
- 3) the employer suffered a specific amount of monetary loss; and
- 4) the loss suffered was caused by the former employee's violation of the covenant.

Employers often face significant challenges in meeting their burdens of proving the third and fourth elements. For example, the former employee will argue that the amount of the lost profits the employer is seeking is speculative. The former employee is also likely to assert that the customer could have ended the relationship at any time. Yet another common defense by the former employee to the award of damages is that it was the customer's displeasure with the employer's services — and not anything that the former employee who signed the restrictive covenant did — that caused the customer to end its relationship with the employer. Therefore, an employer might still have difficulty in collecting the amount of money equivalent to its perceived economic loss even if it can establish that its restrictive covenant was valid and enforceable, it. Additionally, it will have to bear the cost associated with the litigation.

A liquidated damage provision eliminates the problems of proof and causation by establishing a binding and pre-determined formula used to determine the loss. A liquidated damages provision might also provide leverage to the employer in its negotiations with its former employee, since it eliminates one of the more common defenses the former employee would otherwise assert in a resulting restrictive covenant lawsuit.

Like most things in business, however, there is a downside. Including a liquidated damages provision in a restrictive covenant makes it much more difficult for an employer to obtain an injunction against the continued violation. To obtain an injunction, the party seeking the injunction typically is required to demonstrate that monetary damages are *inadequate*, and that the injury it is suffering is "irreparable."

It is usually very difficult to demonstrate that money damages will be inadequate in the face of a liquidated damages provision. Indeed, because the very purpose of the provision is to provide a way to quantify the magnitude of the harm the former employee's violation of the restrictive covenant caused — by applying the pre-determined monetary formula set forth in the provision. Ultimately, therefore, an employee designing a restrictive covenant will need to consider whether its principal goal is to be able to stop a violation of the covenant (in which case it should not include a liquidated damages provision) or whether "cash is king," and its highest priority is to replace the lost revenue from the customer that the former employee improperly solicited or serviced.

The following is a sample liquidated damages provision in a restrictive covenant agreement:

You agree that in the event you violate [paragraphs pertaining to non-service of customers, and non-raiding of employees], the monetary damages to the Company would be material and the amount of such damages would be uncertain and not readily ascertainable. Therefore, in the event that you violate [paragraphs pertaining to non-service of customers, and non-raiding of employees], you agree that in addition to relief at law or in equity, the Company shall be entitled to liquidated damages and to recover its reasonable legal fees from you as follows:

Non-Servicing Obligation

If you breach [paragraphs pertaining to non-service of employees, and non-raiding of customers], you shall pay the Company, as liquidated damages, the Agreed Amount (as defined below):

(i) If you breach the [non-service of customers provision], you shall pay the greater of: (x) 100% of the fees paid by the Customer to the Company during the twelve-month period prior to your last date of employment (the "Initial Amount"); or (y) 100% of the fees paid by the Customer to you or your new employer during the fifteen-month period following your or your employer's work on behalf of such Customer (the "Second Amount"). You will pay the Company the Initial Amount within 20 days of notification by the Company to you of the breach. Should the Second Amount be greater than the Initial Amount, you shall pay the difference within 20 days following such fifteen-month period. You shall send the Company copies of all relevant invoices relating to the servicing of the Customer(s) during such fifteen-month period, concurrently with their submission to the Customer.

Non-Raiding Obligation

If you breach the [non-raiding of employees provision] you shall pay the Company, as liquidated damages, an amount equal to thirty-three percent (33%) of the total annualized compensation (including any bonus or incentive compensation payment) for the last full calendar year (pro-rated if such employee did not work the entire prior calendar year) paid by the Company to each such person or persons hired by you or your employer, along with the Company's reasonable legal fees and recruitment fees, if any.

You agree that upon any breach of this agreement the Company will, in addition to all other available remedies, be entitled to injunctive relief without having to post bond or other security and without having to prove the inadequacy of the available remedies at law.

The temporal duration of the protective covenants contained in this paragraph shall not expire, and shall be tolled during any period in which you are in violation of any of such protective covenants, and all such restrictions shall automatically be extended by the period of your violation of any such restrictions.

A liquidated damages provision may also appear in an extended notice provision. Such a provision might read as follows:

Notice Obligation

(a) You agree to give the Company at least 90 days written notice of the resignation of your employment.

(b) You acknowledge and agree that continuity of senior-level management is essential to the Company and that the notice obligation under this Agreement is being given as part of the inducement and consideration for the Company's entering into this Agreement. You further acknowledge and agree that the monetary damages to the Company resulting from your failure to give the notice described in this section would be uncertain and not readily ascertainable. Therefore, in the event that you fail to provide 90 days written notice of the resignation of your employment, you agree that the Company shall be entitled to, as liquidated damages, an amount equal to (i) your annual compensation divided by 365, multiplied by (ii) 90 minus the number of days of notice given by you. By way of example, if your annual salary is \$150,000 at the time of your resignation and you only provide the Company with three weeks (21 days) notice, you would be obligated to pay the Company \$28,356.16.

As the above examples demonstrate, liquidated damages provisions, if drafted correctly, can act as strong deterrents in preventing departing employees from violating their post-employment obligations, or from failing to provide adequate notice of their departure from the employer.

Forfeiture Clauses

Forfeiture for competition provisions may also act as a strong deterrent to would-be violators of restrictive covenant agreements. A forfeiture for competition provision operates so that the departing employee is required to forfeit a pre-existing employee benefit, such as stock options or a recently paid bonus, if he or she violates the restrictive covenant. The courts' general rationale for upholding forfeiture provisions is based, in part, on the concept of "employee choice." Typically, the logic is that the employee has the clear choice to preserve his or her entitlement to these benefits by refraining from violating the restrictive covenants, or to risk forfeiting these benefits by violating the agreement.

A word of caution in drafting forfeiture provisions: many states, including New York, strongly disfavor forfeiture of wages. Therefore, a forfeiture provision should only be tied to those benefits that would not constitute an earned wage under the law.

Below is a sample of a forfeiture provision in a stock option agreement. This provision was enforced in a New York case involving an IBM stock option agreement:

Forfeiture of Stock Option Awards

A Participant shall not render services for any organization or engage directly or indirectly in any business which, in the judgment of the chief executive officer of the Company or other senior officer designated by the Committee, is or becomes competitive with the Company, or which organization or business, or the rendering of services to such organization or business, is or becomes otherwise prejudicial to or in conflict with the interests of the Company ...

Failure to comply with the provisions of paragraph (a) of this Section prior to, or during the six months after, any exercise, payment or delivery pursuant to an Award **shall cause such exercise, payment or delivery to be rescinded.** The Company shall notify the Participant in writing of any such rescission within two years after such exercise, payment or delivery. Within ten days after receiving such notice from the Company, the Participant shall pay to the Company the amount of any gain realized or payment received as a result of the rescinded exercise, payment or delivery pursuant to an award ...

You agree that the cancellation and rescission provisions of the Plan and this Agreement are reasonable and agree not to challenge the reasonableness of such provisions, even where forfeiture of options granted is the penalty for violation. If you or the Company brings an action to enforce this Agreement and the Company prevails, you will pay all costs and expenses incurred by the Company in connection with that action...

In consideration of this option grant, you agree to comply with the requirements of the Plan and this Agreement, specifically those portions relating to cancellation and rescission of "Awards."

Hiring Talent From Competitive Firms

Thus far, the discussion has focused on how an employer can implement restrictive covenant provisions to protect its customer relationships, and its confidential and proprietary information when existing employees leave the company. Looking at this issue from another perspective, suppose an employer is not seeking to enforce a restrictive covenant, but is seeking to hire an experienced professional to fill an open position. What should the employer learn about a candidate during the interview process *before* it makes an offer of employment?

Does the Candidate Have Continuing Obligations to a Previous Employer?

Although often overlooked, it is crucial to gain a complete understanding of any post-employment obligations a prospective new employee may owe to his or her former employer. Just as your company seeks to implement restrictive covenant provisions that it hopes will deter competitors from hiring away your key employees, the opposite is also true. If a prospective new employee is subject to significant post-employment restrictions, engage in a careful risk-benefit analysis with legal counsel to assess whether it is worth hiring this particular individual, as opposed to another qualified candidate who may not be subject to post-employment restrictions.

There are a few simple steps a company can take to uncover post-employment obligations to which a prospective new-hire may be bound. Consider asking the candidate on the application form and in interviews the following questions:

- Have you ever signed an agreement that contained restrictive covenant provisions? (If so, provide a copy);
- Did your most recent employer include any restrictive covenant or notice provisions in its employee manual or code of conduct? (If so, provide a copy);
- Have you ever signed a benefits package or bonus agreement that contained restrictive covenant provisions? (If so, provide a copy);

- Have you ever received an e-mail or any other correspondence regarding post-employment restrictions your current employer is implementing? (If so, provide a copy).

This list of questions is not exhaustive. A company should consult experienced legal counsel to develop a standard practice and protocol for handling prospective incoming employees.

If a candidate reveals that he or she has post-employment obligations to a former employer, it is imperative that legal counsel review the provisions of any agreement the candidate may have signed. This should occur *before* an offer of employment is made, to allow the new employer to assess the risk in a timely manner. In this regard, the company seeking to enforce its restrictive covenant will sometimes bring a lawsuit against not only its former employee, but also his or her new employer. The claim against the new employer is typically a claim of tortious interference with contract — which essentially is a claim that the new employer sought to have an individual engage in conduct that it knew to be in violation of a pre-existing, valid contract between that individual and his or her prior employer.

If the company makes an offer of employment to this candidate, the company should take an additional step to reduce its own potential liability. The company should require the individual to sign either a detailed offer letter or an employment agreement. These documents should contain not only certain representations by the candidate, but also should represent the financial terms and conditions of employment. The candidate should state that he or she either: 1) is not subject to any post-employment restrictions; or 2) is subject to a specific restriction that is clearly defined in the offer letter.

These written representations will establish that the company made a good faith inquiry into the candidate's post-employment obligations, if the candidate's former employer later calls into question its actions. This representation will also help ensure that the new employee thinks carefully before neglecting to tell a prospective employer about any and all agreements to which he or she might be bound. The new employer could also have a claim against its new employee if it turns out that the written representation is untrue.

Does the Candidate Possess a Former Employer's Documents, Information or Materials (Electronic or Hard Copy)?

Whether or not a candidate is subject to post-employment obligations to a previous employer, it is critical to emphasize to the candidate that upon departing from that company, the candidate must *not* maintain possession of any documents (electronic or hard copy), materials, or confidential or proprietary information of his or her former employer.

During the interview process, ask the candidate whether the former employer had any written policy concerning confidentiality or trade secrets, whether the employee signed any corresponding document, or received any corresponding policy concerning an agreement not to use or disclose such information. Ask for a copy of any such document or agreement the candidate signed and make sure to review it carefully with legal counsel before any offer of employment is made to this candidate. Instruct the candidate not to take anything with him or her when departing from his or her former employer, except for personal items and information that is in the public domain.

Information is considered to be “in the public domain” if it would be available to a third party who is not an employee of the candidate’s former employer, or did not hold a position of confidence with the candidate’s employer. The emphasis here is on items that are truly personal and truly public. For example, a customer proposal that the candidate may have prepared is *not* personal; it is the work product of his or her current employer and the candidate cannot take it, even as a representative sample of his or her “work product.” It is a good idea in particularly sensitive situations for the candidate to have someone witness what he or she packs up or leaves behind.

Also tell the candidate that, on the day of resignation, he or she should return all business files that may have accumulated at home (both electronic and hard copy). If the candidate has a home computer, he or she should take whatever was on the home computer relating to the business of the employer from which he or she is departing, put it on a disk, delete it from the home computer and bring the disk to the former employer on the date of resignation.

Given the extraordinary advances in technology today, employers have numerous methods for tracking what records, electronic and hard copy, a departing employee has accessed and when, and for viewing the content of e-mails and voice-mails sent and received. The last thing a new employer wants to face is a lawsuit filed by a former employer against its new employee for allegedly breaching confidentiality and trade secrets agreements, or for alleged disloyalty to the former employer. There are several reasons for this. First, the new employer could be sued. Second, regardless, the new employer will have to determine whether it will cover the new employee’s litigation expenses. Third, the new employee will have to expend significant time and energy to respond to the suit — time and energy that the new employer would prefer he or she is dedicating to his or her new role at the company. Fourth, the new employer will have to consider whether this is the type of employee it wants at its company, if the employee has allegedly engaged in disloyal conduct, or has allegedly disclosed confidential or proprietary information of a former employer.

If an offer letter is eventually extended to this candidate, the offer letter — which, again, the company should require the candidate to sign — should include a representation from the employee that he or she did not maintain, and will not use or disclose any confidential or proprietary information of the former employer.

Ensuring a Smooth Transition From Former Employer to New Employer

If a candidate accepts an offer of employment, discuss the following points with the candidate before he or she resigns from a current employer:

- Remind the candidate that he or she has a fiduciary duty to act with undivided loyalty to, and in the best interest of, his or her current employer for as long (but no longer than) he or she remains on its payroll.
- Confirm that the candidate will resign to the appropriate person in management at his or her current employer.
- The candidate should not advise any customers, potential customers or co-workers that he or she is planning to resign, before he or she resigns.

- The candidate should be aware that technology has made it possible for the current employer to have access to substantial information to track exactly how loyal he or she has been in the final weeks (or months) of employment. A touch of a button can now provide printouts of everything from phone calls made to customer computer records accessed. This aspect of the “information super-highway” has made it necessary for candidates to be especially careful that their current employer does not view their actions as duplicitous or in violation of their duties of undivided loyalty.
- Even in the absence of a restrictive covenant, the candidate cannot compete with his or her former employer based upon a non-public strategy, information or work product that the current employer prepared or that came to the candidate’s attention by due to his or her position at the current employer.

However, the candidate may be able to solve this problem by re-obtaining this information from the customer or new employer once he or she commences employment with the new employer.

Additionally, encourage the candidate to offer to assist his or her current employer in the orderly transition of active matters and/or files. The candidate should make sure to advise his or her supervisor where necessary and active files are maintained (both hard copy and computer files), and about upcoming customer meetings, deadlines and obligations.

Hiring a Group of Employees Who Departed Collectively from the Same Company

There is one final point to consider in the hiring context: When a company considers hiring a group of employees from the same competitor. As stated above, it is very important to analyze who in the group may have a post-employment restriction and who may not. Although all circumstances are different, it may be possible to bring aboard the employees who have no employment restriction (such as a non-raid provision), before hiring the employees who may be subject to restrictions prohibiting them from hiring employees of their prior employer.

It is also important to understand that the more employees a company hires from the same competing business unit, the exponentially greater the risk that the company will be faced with a claim against it. “En masse” departures leading to group hires therefore require special care and advice from experienced legal counsel, who can fully explain and assess the associated risks.

Conclusion

There is no “magic language” to drafting an enforceable restrictive covenant provision. However, the important first step is to identify precisely the business interests your company most needs to protect, and the employees who are most likely to pose the greatest harm to those interests. A company should tailor its post-employment restrictions accordingly, using the various techniques suggested in this chapter. By doing so, a company will have the greatest chance of achieving the crucial balance the courts favor: It will, on the one hand, protect its legitimate business interests, while on the other hand, allow its former employees freedom of employment in their chosen professions.

Exhibit A

OPTIONS FOR POST-EMPLOYMENT RESTRICTIONS FOR EMPLOYEES

Forward-thinking owners and members of senior management should put in place a mix of strategies to protect their companies against the inevitable departure of key employees. Since valued employees and hard earned client relationships are among the most important assets of a marketing service business, a company is well advised to consider what mix of legal techniques will best preserve and protect those assets. Suggestions follow, based on owners and/or the general categories of employment listed below.

- Category 1: Top Level Executive Management
- Category 2: Senior Level Management
- Category 3: Middle Level Management
- Category 4: Rank-and-file
- Category 5: Support staff with no client contract

NOTICE OF RESIGNATION

- Category 1: 120-180 days
- Category 2: 60-90 days
- Category 3: 30 days
- Categories 4 & 5: 14 days

NON-COMPETITION (CANNOT WORK FOR A LISTED GROUP OF MAJOR COMPETITORS)

- Category 1: Term of employment contract plus six (6) months

RESTRICTIONS ON SERVICING COMPETITIVE CLIENTS OR COMPETITIVE BRANDS (AT ANOTHER AGENCY OR IN-HOUSE)

- Category 1: Term of employment plus one (1) year for all clients of any company with common ownership to “parent” company (“the Group”)
- Category 2: Term of employment plus one (1) year, but limited to product, brand or service of a client of any company within the Group in respect of which the employee has or had a direct servicing relationship, supervisory responsibility or other involvement
- Category 3: Term of employment plus six (6) months, but limited to product, brand or service of a client of any company within the Group in respect of which the employee has or had a direct servicing relationship, supervisory responsibility or other involvement

NON-SOLICITATION / NON-SERVICING OF CLIENTS

Category 1: Term of employment plus one (1) year for all clients and prospective clients of any company within the Group

Categories 2, 3 & 4: Term of employment plus one (1) year, but limited to product, brand or service of a client or prospective client of any company within the Group in respect of which the employee has or had a direct servicing relationship, supervisory responsibility or other involvement, or a direct participation, supervisory responsibility or other involvement in a new business pitch or the preparation of such a pitch

NON-HIRING OF EMPLOYEES, FREELANCERS AND EXCLUSIVE CONSULTANTS

Categories 1,2,3 & 4: Term of employment plus one (1) year for all employees, freelancers and of exclusive consultants to any company within the Group

For more information, please contact: Michael C. Lasky, Davis & Gilbert LLP
(212) 468-4849 / mlasky@dglaw.com
1740 Broadway, New York, NY 10019

Copyright 2007 Davis & Gilbert LLP. Used by permission.