



RESTRICTIVE COVENANTS:

PROTECTING THE VALUE OF YOUR BUSINESS

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29th November 2007**

Protecting the value of your business – the use of restrictive covenants.

Why do I need restrictive covenants?

You have spent valuable time and resources building the assets that make up your business. The value of your business is not just, of course, in the value such tangible assets such as stock, property or machinery. There is measurable value in the client lists that you have assembled for marketing, the names of those you know will make repeat orders, and the workforce that you retain who know your business and are trained to meet requirements.

What if tomorrow you found that 50% of your clients had defected to a rival business? And what if that business had made job offers to (the most capable) 50% of your staff? It would seem improbable, but not if one of your existing employees left to set up on his own or join a competitor, and made use of his connections with your clients, your confidential business information, and influence over the employees with whom he worked.

By protecting your business you are not only taking measures to prevent such problems occurring, but are adding value to the business in the eyes of any potential purchaser who wants to know his acquisition will be a good investment. You would not go home at night without locking the office/warehouse/factory doors – so why risk allowing an opportunist to steal other important assets?

Confidential information

In order to perform their duties, members of staff will need access to varying degrees of confidential information about your business. Purchase Ledger staff will have access to the discounts you negotiate with suppliers, which in the hands of a competitor would enable them to gain efficiencies they would not otherwise have enjoyed. Technical and IT staff will have access to details about machinery, computer hardware and software, which may be unique to your business. Sales staff will have knowledge of the names and addresses of your clients, and will know exactly who to speak with to secure a sale. All of this information would be useful to a competitor, and in the wrong hands could damage your business.

The effect of a confidentiality clause in the contract of employment

Without a confidentiality covenant an employee (whilst he remains an employee) is bound to keep confidential your trade secrets and similar confidential information. He may not collect and remove confidential information for use later, when the employment has ceased. However, once the employment is terminated the ex-employee is free to use such

information to his advantage, provided he has not stolen or deliberately memorised the confidential information in order to make use of it.

A properly drafted clause will;

- Define the type of information that the employer considers ‘confidential’
- Specify that it binds the individual indefinitely in time, both during and after the end of the employment.
- Protect the employer against the disclosure of the confidential information to benefit a competing company, or for any other purpose except where it is disclosed by order of a court or in the public interest (i.e. whistleblowing).

Having implemented such a clause you must ensure that you treat all confidential information as being confidential – that is, do not allow unauthorised disclosure and ensure such information is kept safely and securely.

Business Connections

You invest time and resources into building client connections and these are assets. Without appropriate covenants, properly implemented, former employees could set up in a competing business and entice those clients away. Some of your employees will have closer connections with major clients than you do yourself.

‘Boilerplate’ clauses are available for this purpose, but care needs to be taken (more so than over any other clauses in the contract of employment) to ensure that the clauses are drafted in such a way that they are enforceable. If they are to be enforceable at all, they must be ‘tightly drafted’, meaning that you cannot put more onerous restriction upon ex-employees than are absolutely necessary to protect your legitimate business interests. The covenants must take into account the needs of your particular business, and the measures that would be necessary to prevent a former employee from obtaining an unfair advantage in the marketplace (or handing such an advantage to their next employer).

Different clauses may be necessary for employees of different seniority/roles.

Things to consider;

1. If the employee was to leave tomorrow how long would their replacement need to consolidate the business relationship with the clients? You would be required to justify your answer.
2. Which products/services does the employee deal in?
3. What geographical area am I trading in, and is the work of this particular employee confined to a smaller geographical area?

The Stability of your Workforce

Your employees are trained to do the job, know your methods and the requirements of specific customers. Each time an employee leaves there is a cost to the business of recruiting (including recruitment agency fees), retraining and general 'down time' whilst the new person gets up to speed. When this happens with individual employees it can be difficult, but you cannot stop people leaving. However, it would be disastrous for most businesses to receive resignation letters from an entire department at one time (as does sometimes happen). As a worse insult you could be left with the under-performers who were not worth poaching!

It is not possible to stop people from leaving – consider what notice periods are adequate. Don't have too long a notice period of you could end up paying for long periods of garden leave.

Clauses can prevent or deter employees from (for a defined period) poaching their colleagues. These are, admittedly, difficult to enforce, but can act as a disincentive where employees (and their new employers) know that there is a risk of being found in breach.

Such clauses should again be tailored to the circumstances to be most effective.

Garden leave.

A 'garden leave' clause is one which permits the employer to send the employee home on paid leave (usually during the notice period) and provide no work for him to do.

This might sound like a rather illogical decision – you would be effectively paying the employee to stay at home and do nothing but it can be a useful way of protecting your client list and confidential information.

- During a period of garden leave the employee is not having contact with your customers and it gives you time to consolidate your relationship with those customers. The employee's customer connections will weaken during that period of inactivity.
- The employee is still bound by the normal requirements of loyalty which bind every employee – so he cannot undertake any competitive activity.
- Garden leave can be used as a means of preventing the employee from collecting confidential information or using the time during the notice period to persuade clients to move with them to their new company.

Implementation

It is very important that you have the contract containing the restrictions signed as part of the offer to employ – don't leave it until a few weeks after they start, or the end of the probationary period. This is essential to the covenants being enforceable. (Tip – ensure you can dismiss on 1 weeks notice during the probationary period. That way if a new employee is obviously unsuitable, you can end the contract quickly without too much cost to the company).

If you need to implement new clauses for existing employees you must ensure that there is consideration passing to that employee in return for them making the promise contained in the covenants. When the covenants are entered into as part of a new job offer, the job itself is the consideration. Later, consideration could be in the form of the following;

- Implement the new clauses at pay increase time. The employee is given the pay increase under a new contract which also contains the covenants.
- Make a one-off payment as consideration.
- Implement the new clauses as part of a new contract where a promotion or new job has been offered to an existing employee.

We are often asked to assist in cases where the client company has contracts which contain well drafted covenants, but without consideration these cannot be enforced.

Do not invalidate the covenants

If an employer behaves in any way which fundamentally breaches the employee's contract, the employer will risk invalidating the covenants. In cases where it is important to retain the right to rely on the covenants, seek advice prior to dismissing, or in relation to any serious grievances raised by the employee.

Enforcement

Litigation is expensive. However, this factor can also work in your favour as the ex-employee and their new employer will want to avoid litigation as much as you will.

You need to be vigilant if there is a risk of a former employee breaching a covenant. Watch out for patterns in withdrawal of repeat business, and make use of any information you can glean through other sources in the industry.

- If a former employee is in breach of his covenants, often a few strongly worded letters requiring that he gives undertakings that he will not breach/ will cease any action which is in breach are enough to resolve the problem, provided the covenants are appropriate and well drafted, and there is valid consideration.

- If the former employee has been hired by another business, you can write to the directors and put them on notice that they are assisting the employee to breach his contract with you. The letter would advise that you will if necessary take action against both their business and the former employee.
- Provided you act quickly, it is possible to ask the court for an injunction, to prevent the former employee (and his new employer) from breaching the covenant – i.e. to prevent them from doing any further business with your client, which they have ‘poached’.
- If covenants are breached, and you suffer loss, you can request that the court orders the other party to pay you an account of the profits they have made due to the breach – they would effectively be working for nothing, just to hand their profit over to you.

Summary

Here are some general points;

- Covenants to restrict an employee’s activities after the employment has terminated need to be skilfully drafted, and must be suitable not only for your business, but for the circumstances of that particular employee. It is always best to get professional assistance.
- Covenants must be drafted as ‘tightly’ as possible in order to be enforceable.
- Decide which categories of information should be treated as confidential, and ensure that within your company employees with access to that information know that it is confidential and what is expected of them.
- Ensure that all employees with customer connections sign appropriate covenants preventing them from exploiting their connections for an appropriate period after the employment has ended.
- Where an employee is to be dismissed or resigns in circumstances where there is a risk of them exploiting a customer connection, consider putting them on garden leave so that the information/connection becomes ‘stale’ and less valuable to a competing business.
- Ensure that you as the employer do not act in breach the contract of employment – that could invalidate the covenants and prevent you from relying on them.
- Review the covenants regularly (every 1-2 years) and on any major changes in the business, or where the employee changes job role.