

Guide to restrictive covenants in the employment context

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This guide sets out the key issues to consider when drafting and seeking to enforce post-termination restrictive covenants, together with some **practical tips** for dealing with restrictive covenant issues and disputes.

1 The need for restrictive covenants

Employees may acquire confidential information and knowledge of key business interests including such things as the identity of clients, client requirements and pricing, suppliers, knowledge of the workforce and information about future business strategy during their employment. It is often tempting for employees to use this information after their employment has ended, either in business on their own account or to further the interests of a new employer who may be a competitor. To try to protect their businesses from such threats many employers incorporate post-termination restrictive covenants into employment contracts. The effectiveness of such restrictions depends on a delicate balance between the right of employers to protect legitimate business interests and the right of individuals to use their skills for the benefit of themselves and the public at large.

2 Legal starting point

The general position is that post-termination restrictive covenants are void on public policy grounds as being in restraint of trade unless they protect a legitimate business interest and are drafted as narrowly as possible in protecting that interest.

Legitimate business interests which covenants may protect include connections with clients and customers (and, in some cases, prospective clients and customers), trade connections with suppliers, confidential information (including, but not limited to, trade secrets) and stability of the workforce. A protectable interest in relationships may still exist even where the relevant information is in the public domain including on social media (*East of England Schools CIC v Palmer and another*). This is not an exhaustive list and so other business interests may potentially be legitimate and therefore capable of protection.

3 Drafting restrictive covenants

3.1 What is a restrictive covenant?

A restrictive covenant is a contractual clause restricting the post-employment activities of the worker for a limited period after the employment relationship ends in order to protect the employer's legitimate business interests. Types of restrictive covenant include non-compete, non-dealing and non-solicitation (for example, in relation to clients and suppliers), non-poaching (of staff) and non-disclosure of confidential information covenants.

3.2 'Reasonable' protection

A covenant which is wider than is reasonably necessary to protect the legitimate business interests of the business is at risk of being unenforceable. It is therefore important that employers carefully consider whether a covenant which is narrower in scope might still protect the employer's interests. The Courts consider the reasonableness of a covenant at the time it is entered into, not at the time of enforcement. (*Commercial Plastics v Vincent* (1965)). Factors affecting reasonableness vary but may include scope, duration, geographical location (if appropriate in the context of the business), the nature of the employer's business, the nature of the employee's role and whether the covenant is usual in the sector. These variables are considered opposite.

3.3 What type of covenant?

The types of covenant that are appropriate will depend on the business interests that the employer is seeking to protect. For example, non-solicitation of customers and non-dealing with customers covenants may be sufficient to protect a business where the business interest that needs protection is customer contact lists.

Non-compete covenants tend to be the most onerous covenants for workers as they may severely limit the ability of an individual to make a living for the duration of the covenant period. They are also the most likely type of covenant to be found to be in restraint of trade and are therefore the most difficult to enforce. The judgment in *Thomas v Farr plc and another* (2007) makes it clear that when assessing whether a non-compete covenant should be enforced, Courts will first consider whether a non-solicitation clause alone would have provided adequate protection. However, non-solicitation covenants can be less helpful in practice since it can be much more difficult to prove breach.

3.4 Who should be bound by restrictive covenants?

Although it can be tempting, from an administration perspective, to apply the same covenants to the whole workforce, this can make it more difficult to enforce the covenants. For example, it may be necessary for an employer to protect its legitimate interests by imposing a non-solicitation covenant in respect of customers on managers of a certain level, because of the level of contact and influence that those managers have with customers. The same may not be true of administrative staff who have very little or no substantive contact with customers. If the same template covenants apply throughout the workforce it may be difficult to justify the necessity of the covenants in relation to the individuals who pose the greatest threat to the employer post-termination and all the covenants are then at risk of being unenforceable.

3.5 Preambles

It is sometimes helpful to include a preamble to the covenant explaining its purpose. For example, in *TFS Derivatives v Morgan* (2005) a covenant was upheld where it began:

"In view of your access to sensitive information about the group and its business and since you are likely to acquire personal knowledge of and influence over its clients and in order to protect the goodwill of the group..."

However, preambles should be used only where carefully considered. If there are other legitimate business interests in the employer's contemplation when the contract is agreed and they are not specified in the preamble, this can be very unhelpful and affect the prospects of the relevant covenant being upheld.

3.6 Length of the covenant

A shorter covenant benefits the worker, but a covenant with a long duration will usually be desired by an employer as this gives the employer more time to protect its legitimate business interests. Despite this, employers must take care in balancing the need to protect the business with the value of enforceability. A covenant which cannot be enforced because it is too long in duration will of course be of no help at all to the employer.

3.6.1 6-12 months

It is common practice for restrictive covenants in employment relationships to apply for restricted periods post-termination of between six and 12 months. Covenants at the longer end are more likely to be reasonable for senior employees than 'run of the mill' employees (*Beckett Investment Management Group Ltd v Hall* (2007)). However, whether a restrictive covenant is enforceable depends on the particular circumstances. For example, if the legitimate business interest to be protected by the covenant is confidential information, the Court will look at for how long the information remains confidential before it becomes obsolete or enters the public domain. The longer the period, the greater the reasonableness of seeking a covenant with a longer period of restriction in order to protect that information. Equally, if contact between a business and its clients is infrequent, or if clients are locked into contracts for a minimum period, this may justify a longer restricted period, because it is only at the end of the period that the business is likely to suffer damage as a result of solicitation.

3.6.2 Longer restrictions

A period of restraint in excess of 12 months will usually be unenforceable in an employment context. However, there are exceptions and in some cases, two-year employment covenants have been enforced by the Court. Most of the case law in this regard concerns covenants which are narrower in scope than non-competes, such as non-solicitation covenants and non-dealing covenants (*GW Plowman v Ash* (1964), *Spafax Ltd v Harrison* (1980) and *Dairy Crest v Pigott* (1989)). Whilst non-compete restrictions in excess of 12 months may potentially be enforceable this is likely to apply only in exceptional circumstances.

3.6.3 Short covenants, wide scope

If other aspects of the scope of the covenant need to be wide to protect the business interests, one option to improve the likelihood of enforceability is to include a covenant which is relatively short in duration. In *Coppage and another v Safetynet Security Ltd* (2013), the Court of Appeal upheld a covenant which restricted a former employee from soliciting any customers of his former employer that he dealt with at any time during his employment for a period of six months following the termination of his employment. Generally, non-solicitation covenants should be limited to those with whom the employee had contact during a specified period immediately before termination of the employment to be enforceable, because this is usually sufficient to protect the legitimate interests of the business. However, in this case the Court held that the restriction was reasonable, despite its breadth, as it applied only for six months after termination.

3.7 Geographical restrictions

In non-competes, the advantage of a covenant which identifies the territory in which the company conducts its business is certainty. It leaves little room for doubt as to the area in which the activity is prohibited. Geographical restrictions also limit the covenant's scope, thereby potentially improving enforceability in appropriate circumstances. However, territory-specific covenants may be inappropriate for many businesses since:

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the nature of the business may not be defined by geography since in some businesses competition can take place from any location; and

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it is difficult to take account of any expansion of the territory in which the activity is undertaken between the date the covenants are entered into and the date the employment terminates.

An alternative is to draft a non-compete covenant by reference to the definition of prohibited competitive activity rather than the prohibition of a particular activity within a defined territory. For example, a financial services company in which it is not key where the work is performed may seek to restrict an employee post-termination by setting out the specific type of financial services the employee is prohibited from engaging in for a period-post-termination, by reference to what he does during the latter course of his employment.

3.8 Fellow employees

To maximise the chances of enforceability of a non-solicitation of employee covenant, the definition of fellow employees should, ideally be limited: (i) to current employees who were employed by the company when the employment terminates and with whom the employee had material dealings during a specified period prior to the termination of his employment; and (ii) by reference to some element of importance, for example, seniority/employees in a technical capacity.

3.9 Consideration

The party benefitting from restrictive covenants must provide consideration for the covenants to be enforceable. Where restrictive covenants are contained in a service agreement, this is not an issue as there are usually a number of forms of consideration contained in the agreement (for example, salary and benefits). However, where restrictive covenants are contained in a separate side agreement, it is important to check that there is consideration.

3.10 Construction and the 'blue pencil test'

Covenants are interpreted in the context of the agreement as a whole and the reasonable expectation of the parties at the time the contract was made can be taken into account.

Courts will not re-write a covenant or introduce appropriate limitations if it is too broad to be enforceable (*J A Mont (UK) Ltd v Mills* (1993)). It is not therefore possible to include different alternative periods of duration for a covenant, as a Court will not select the most appropriate period, but find the whole covenant unenforceable instead. However, the Court may sever unenforceable provisions from the rest of the covenants if they can be severed without the need to add new wording and severing the unenforceable wording does not change the character of the contract. This is known as applying the 'blue pencil test'.

3.11 Updating covenants

Covenants should be reviewed and updated when an employee's role changes or he is promoted. This is so that the protection provided by the covenants reflects the legitimate interests of the employer that it seeks to protect. Employers should use changes to employment contracts as an opportunity to update the restrictive covenants. Employees may be more amenable to agreeing covenants when offered a pay rise or promotion. This will also provide clear consideration for the covenants.

In *Willow Oak Developments Limited v Silverwood* (2006), the Court of Appeal held that an employer who is being faced with widespread poaching of staff by a competitor is entitled to protect itself by introducing restrictive covenants by way of a variation to a contract of employment and that the employees must accept reasonable steps to that end as part of their duty of co-operation. However, care must be taken when seeking to introduce new restrictive covenants to ensure that agreement has been reached (and documented) between the parties. New restrictive covenants introduced in company handbooks may be problematic if there is no evidence that the employee has agreed to be bound by them (*Crowson Fabrics Limited v Rider and Others* (2007)).

4 Other contractual issues to consider

4.1 Interaction with garden leave

Including both a garden leave clause (which provides that the employer can require the employee to remain employed by the employer during all or part of his notice period but is not required to work during it) and post-termination restrictive covenants in a contract of employment provides the employer with two options in relation to protection of its interests when it is decided that the employment will terminate.

The advantages of garden leave are that: (i) the employee continues to owe all his contractual duties (including implied terms such as the duty of fidelity) to the employer; (ii) it may allow for a useful handover period; (iii) a paid period of non-competition may be more palatable to an employee than an unpaid period; and (iv) garden leave clauses are less likely to be challenged on length than restrictive covenants (*Symbian Ltd v Christensen* (2000)). The main disadvantage is that the employer needs to continue to provide all contractual pay and, unless expressly excluded in the contract, benefits during the garden leave period.

Garden leave clauses and restrictive covenants can be used in conjunction with each other. To increase the chances of enforcing restrictive covenants applying on termination of employment after a period of garden leave, the covenants should provide that the restricted period under the covenants will be reduced by any time spent on garden leave (Credit Suisse Asset Management Ltd v Armstrong and others (1996)).

4.2 Breaches of contract by the employer

Note that an employer which breaches the relevant employee's employment contract may not be able to rely on the post-termination restrictive covenants.

If covenants are a key issue for the business, it is prudent to include a payment in lieu of notice clause in the employment contract so that the employer will not be in breach of contract if it wishes to terminate the contract immediately without cause by making a payment in lieu of notice. To do so in the absence of an express clause is possible, however it is a breach of contract. If the employer's disciplinary policy is contractual (which is not advisable), this should also be followed where covenants are important in order to avoid a breach of contract.

4.3 Fiduciary duties – a further tactic

Directors and senior employees who take steps to compete before leaving the employer, may be in breach of their fiduciary duties. This is an alternative route that employers can pursue either independently or alongside enforcement action in relation to restrictive covenants. Fiduciary duties are owed only by employees with a special status or role by which they have placed themselves in a position where they must act solely in the interests of their employer. Fiduciary duties cannot be trumped by a consideration of restraint of trade principles which form the basis of all challenges to the enforceability of restrictive covenants.

5 Enforcing restrictive covenants

5.1 Uncertainty

Enforcing restrictive covenants is usually fraught with difficulties for an employer because the fact-specific nature of the cases in this area means that there is no certainty as to which covenants will or will not be upheld by the Courts.

In order to enforce a covenant against an employee or, more usually, former employee, where the employee has breached it or intends to do so, the employer must seek a Court order. The Court will consider all the circumstances and retains a discretion to decline to do so in all cases in which it is being asked to grant injunctive relief. The key to success in restrictive covenant disputes therefore often lies in establishing the moral high ground. For example, employers seeking an injunction should be careful not to act unreasonably during the pre-action stages, as this may be taken into account by the Court.

5.2 Deciding whether to take legal action

Employers should take legal advice regarding covenants prior to taking action to enforce them. Losing a case can be costly since the losing party generally pays between 60-80% of the winning party's costs and injunctions are expensive and time-intensive to pursue. Moreover, if an employer has incorporated a standard set of covenants in its employment contracts and they are held to be unenforceable against one employee, this may create an unhelpful precedent for the employer in relation to other employees who seek to challenge the covenants, and reduce any deterrent value that the covenants may have otherwise had. On the other hand, a successful claim against a former employee who has breached covenants, will send a clear deterrent message to any future departing employees who may be inclined to carry on activities in breach of their restrictions.

5.3 Key remedies

5.3.1 Interim injunctions

An employer seeking to enforce a restrictive covenant can seek an interim injunction from the Court which stops or prevents the employee from breaching the covenant. For example, an injunction may restrict an employee's ability to commence a new job which would be in breach of covenant. This type of immediate action can be necessary to prevent serious damage to an employer's business. Employers need to proceed quickly as delay makes it less likely that the Court will grant an injunction. Types of injunction an employer can seek are:

- (i) injunctions enforcing a period of garden leave;
- (ii) injunctions enforcing post-termination restrictive covenants;
- (iii) injunctions preventing the use of the employer's confidential information; and
- (iv) springboard injunctions stopping the commercial advantage obtained as the result of a breach of a covenant.

5.3.2 Damages

Alternatively, employers can, after the event, seek damages for breach of covenants. If particular loss is attributable to the breach of a covenant, damages are likely to be the appropriate remedy. However, it can often be difficult to establish loss which is clearly caused by the employee's breach, and often it is more important to prevent damage to the business in the first place, hence the value of seeking an interim injunction.

5.4 Account of profits

If it is difficult for an employer to establish loss as a result of breach of a restrictive covenant (for instance, because it is difficult to establish with certainty that a piece of work would have been awarded to the employer had the covenant not been breached), an alternative remedy may be for an account of profits. That is, recovery of the profits that the individual has been able to make as a result of a breach of fiduciary duty or confidence, or exceptionally, in breach of contract claims. Account of profits is a discretionary remedy and the Court will take account of factors including, any delay in bringing proceedings, the conduct of the employer and whether it has acquiesced in the conduct of the individual in breach.

5.5 Suing competitors

A former employer can potentially sue the new employer where the new employer induces the individual to breach his contract of employment with the former employer. Conspiracy and inducement to breach an employment contract are economic torts. If the employer is in doubt as to whether the new employer is aware of the covenants (a necessary element for an inducement to breach), it should consider writing to the new employer to put it on notice that this is the case, before pursuing action directly against the former employee and new employer.

6 Restrictive covenants and TUPE

Enforcing covenants applying to employees who have transferred to a new employer under the Transfer of Undertakings (Protection of Employment) Regulations 2006 ('TUPE'), can be problematic. This is because it is not always clear what the covenant actually applies to as result of the covenant having been drafted with the transferor's business in mind. In *Morris Angel & Son Ltd v Hollande* (1993), the transferor's sale of its business to the claimant transferee was governed by TUPE. A non-solicitation covenant which precluded an employee from doing business with "any person firm or company who has at any time during the one year immediately preceding such cesser (i.e cessation of employment) done business with the Group" was held not to extend to the claimant transferee's clients, because these were not in contemplation at the time the covenant was drafted.

The problem with updating restrictive covenants following a TUPE transfer is that most changes to terms and conditions by reason of a TUPE transfer are void. Transferee employers therefore need to look at some novel options for incorporating valid binding covenants into the contracts of transferred employees, which may include dismissing and offering re-engagement on the same terms and conditions of employment with the addition of restrictive covenants. Such an approach is risky and would need to be carefully managed to minimise the risk of legal claims arising from it. Legal advice should be sought before taking such action.

7 Covenants in other employment-related documents

7.1 More than one set of covenants

Where different sets of covenants are contained in different documents which apply to an individual, a Court may potentially enforce only the least restrictive set of covenants.

7.2 Share plans, bonus plans and deferred remuneration structures

Documents such as share plans, bonus plans and deferred remuneration structures may afford the opportunity to include 'soft' covenants which are pre-conditions to receipt of the remuneration by the individual.

However, such arrangements should be considered carefully, as they may also be in restraint of trade. In *Sadler v Imperial Life Assurance Co of Canada* (1988), the High Court considered a deferred commission arrangement which paid out on a reducing scale during the first 10 years of a policy that he had sold and provided that no further commission was payable if, after the termination of his employment the individual joined a competitor. The High Court held that the deferred commission was an unlawful restraint of trade since it was a direct incentive to limit the claimant's future activities.

7.3 Consultancy agreements

If post-termination restrictive covenants are contained in a consultancy agreement, this will be one factor which a Court, Tribunal or HMRC may use as an indicator that the individual is in fact an employee rather than a genuine consultant. The value of the covenant and the nature of the engagements will therefore be important considerations before including post-termination restrictive covenants in a consultancy agreement.

8 The international angle

This note deals with the position in England and Wales. However, public policy on restrictive covenants varies among countries (for example, they are unenforceable in some jurisdictions and payments must be made in others). It is therefore advisable to obtain country-specific legal advice if seeking to implement or enforce covenants in other jurisdictions.

It is worth noting that restrictive covenants included in the terms of a share incentive or cash bonus scheme subject to a foreign governing law will not be enforced by English courts if they would be unenforceable as a matter of public policy under English law (*Duarte v Black and Decker* (2007)).

9 Key practical tips

9.1 Drafting covenants

- > **Short separate covenants.** Separate requirements into short separate covenants since separate promises are more likely to be treated as severable if one is unenforceable.
- > **No Court amendments.** Stating that a covenant is subject to such restraints as the Court deems appropriate is unlikely to work.
- > **Consideration.** Ensure there is consideration from the company for the restrictive covenants.
- > **No blanket covenants.** Having one template set of covenants applied to all employees in an organisation risks them being unenforceable for at least some employees.

- > **Avoid multiple sets of covenants.** There is a risk that if different sets of covenants are contained in different documents which apply to an individual, a Court may potentially enforce only the least restrictive set of covenants.
- > **Update on promotion.** Remember to consider updating covenants when an individual is promoted or moves to a new role.
- > **Agreement.** When introducing new covenants, make sure there is evidence that the employee agrees to them.
- > **Avoid breaching the employment contract.** Where an employee's employment is terminated, and the covenants provide valuable protection, take particular care to act in accordance with the terms of the contract, as restrictive covenants may be unenforceable if the employer breaches the employment contract.

9.2 Enforcing covenants

- > **Put departing employee on notice.** Make sure that departing employees are aware of the restrictions that apply to them.
- > **Investigation.** Conduct a thorough investigation as soon as you suspect an individual may be in breach of restrictive covenants. This may include forensic IT analysis (subject to data protection and privacy laws) and interviewing the individual's colleagues.
- > **Fiduciary duties.** If dealing with senior employees, consider whether they owe fiduciary duties to the company as this may be helpful, particularly if the covenants are not robust or ordinarily enforceable.
- > **Letter before action.** Send the employee a letter before action prior to seeking a remedy from a Court.
- > **Put new employer on notice.** Consider writing to the employee's new employer to put it on notice that the individual is breaching his covenants.
- > **Consider implications of enforcement action.** Consider carefully whether to take legal action if covenants are breached. Seek legal advice on whether the covenants are likely to be enforceable. Note that losing a case could be expensive and set an unhelpful precedent.
- > **Do not delay.** If you intend to pursue an injunction, do not delay. Delays can make it less likely that the Court will grant an injunction.
- > **Consider mediation.** It may be possible to agree a deal with the employee that involves some compromise from both sides. Mediation is quick and confidential so can be useful in restrictive covenant disputes.

For further information, please get in touch with one of the below contacts or your usual Linklaters Employment and Incentives contact.

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