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July 20, 2011

RESTRICTIVE COVENANTS: How to Prevent the Employees from Appropriating Your Business.

I. *The Types of Restrictive Covenants.*

There are three basic types of Restrictive Covenants that an employer may use to safeguard against employees appropriating the company's customers and other valuable assets. To obtain the greatest benefit from this Newsletter, one must understand and distinguish those three types:

A "Non-Compete" is the most restrictive of these agreements, in that it typically prohibits a former employee from working for a competing business in a designated geographical area for a period of months or years after the employment relationship terminates.

A "Non-Service" is less restrictive than a "Non-Compete", in that it allows the former employee to work for a competing business, but prohibits the former employee from transacting business with the former employer's customers. The prohibition applies without regard to whether the transaction was initiated by the former employee or by the customer.

A "Non-Solicit" is the least restrictive, in that it allows the former employee to work for a competing business and to accept business from the former employer's customers, but prohibits the former employee from actively soliciting business from the former employer's customers.

Prior to the 1976 Court of Appeals decision in *Reed, Roberts Associates, Inc. v. Strauman*,¹ employers routinely required significant employees, especially sales people, to sign agreements containing broad "Non-Compete" clauses. After that decision, business people and legal experts (judges and lawyers alike) often failed to distinguish "Non-Competes" from the less restrictive "Non-Service" and "Non-Solicit" clauses. As a

¹ 40 N.Y.2d 303; 386 N.Y.S.2d 677 (1976)

result, many employers felt that any post employment restrictive covenant was unlikely to be enforced in Court and was therefore of little or no use.

II. *More Recent History.*

Fortunately, as a result of several subsequent decisions of the lower Courts and especially a 1999 Court of Appeals decision², an employer can now reasonably expect Courts to analyze the relevant circumstances and the nature of the restriction to determine whether the covenant: (a) is reasonably limited in length and scope; (b) does no more than protect the employer's valuable business assets and (c) does not unreasonably prevent the employee from earning a living. Courts in New York and most other states³ will generally enforce "Non-Service" or "Non-Solicit" clauses that satisfy these criteria.

III. *Recommended Restrictive Covenants.*

Courts may, under very special circumstances, enforce a true "Non-Compete" clause when dealing with a very extraordinary employee⁴.

However, we find that in most cases our clients' needs are satisfied by the less restrictive "Non-Service" and "Non-Solicit" clauses.

When designing "Non-Service" and "Non-Solicit" clauses, we urge our clients to limit the restriction so that it provides just enough protection without unreasonably limiting the employee's ability to earn a living. For example, we try to keep the restricted period relatively short...just long enough to allow the employer to introduce a replacement employee and take substantial steps to solidify the customer's relationship with the Company through the replacement employee. In most cases keeping the former employee away from the customers for six or nine months should be more than enough to solidify the relationships.

Likewise, we urge clients to exclude from the Restrictive Covenant's coverage: (a) customers with whom the employee did business prior to hiring by this company and (b) customers with which the employee had no contact while employed by the company. The New York Court of Appeals has ruled that applying Restrictive Covenants to these types of customers is inherently unreasonable.⁵

² See *BDO Seidman v. Hirshberg*, 93 N.Y.2d 382; 690 N.Y.S.2d 854 (1999)

³ California is a notable exception, since that state's Supreme Court ruled in 2008 that Section 166001 of the California Business and Professions Code prohibits the enforcement of both non-compete and non-service clauses. *See Edwards v. Arthur Andersen LLP*, 44 Cal.4th 937 (2008)

⁴ When the employee's services are "unique or extraordinary" as discussed in *ABC v Wolf American Broadcasting Cos., Inc. v. Wolf*, 52 N.Y.2d 394, 438 N.Y.S.2d 482 (1985) or when the employee was a member of "an elite group that develops IBM's corporate strategy" and "worked for years with some of the crown jewels of IBM's technology" *Int'l Bus. Machines, Corp. v. Papermaster*, No. 08-CV-9078 (KMK), 2008 WL 4974508 (S.D.N.Y. Nov. 21, 2008)

⁵ *BDO Seidman v. Hirshberg*, 93 N.Y.2d 382; 690 N.Y.S.2d 854 (1999)

IV. *Other Protections for the Employer.*

We also typically include several other provisions intended to prevent the employee from appropriating the company's assets and to protect the employer in other significant ways. These may include:

1. Protection of Confidential Information. All employee agreements should include provisions which prohibit the employee, both during and following employment, from disclosing or making unauthorized use of the employer's Confidential Information.
2. Protection of Company Employees. An agreement may prohibit a departing employee from hiring away your work force.
3. Protection of Company Intellectual Property. Such agreements typically confirm the employer's ownership of all inventions and other innovations to which the employee may have contributed during the course of employment.
4. Protection of Supply Sources. While Restrictive Covenants are most often used to protect against the appropriation of customers and clients, they may also be utilized in the appropriate circumstances to protect valuable and hard to find sources of products and services.
5. Return of Company Equipment. These agreements can identify company property in the employee's possession (laptop PCs, PDAs, cell phones, and the like) and fortify the requirement that they be returned to the Company when employment terminates.
6. Assurance that there is no Restrictive Covenant or Court Order Protecting another Employer. The employee should warrant that his or her working for your company will not violate a restrictive covenant given to another company or any Court order.
7. Confirmation of Employment at Will. It can never hurt to get written confirmation that the employee may be terminated, with or without cause, at any time.

V. *New York Sales People.*

Any company that employs "commission salespersons" in New York State has additional motivation and opportunity to utilize Restrictive Covenants to protect its business assets.

New York recently adopted legislation requiring that the compensation terms of all commission salespersons be "reduced to writing, signed by both the employer and the

commission salesperson.”⁶ The state legislature established the written agreement requirement to protect the salesperson’s right to his or her commissions. However, since the law now requires a written agreement for all commission salespersons, there is no reason that the employer should not include some employer protection in that same document. A provision intended to reasonably restrict the employee’s ability to appropriate and use the employer’s customers, confidential information and other valuable assets to compete with the employer after the employment relationship terminates should be included in all employment agreements, including those adopted to satisfy this legal requirement.

VI. *What Should a Company Do?*

Any company that employs salespeople or anyone else that could appropriate and use the company’s customers, suppliers, confidential information and/or other valuable assets to unfairly compete with the company after the employment relationship, should protect itself from potentially devastating damage by requiring all such employees to enter into reasonable Restrictive Covenants of the type discussed in this Newsletter.

Richard H. Waxman, P.C. will answer your questions about this and other employment law issues, and how they might apply to your business; and we will help you prepare the required documents...all for a reasonable fee.

Please call or e-mail if you have any questions.

Very truly yours,

Richard H. Waxman

If you wish to learn more about our Employment Law practice, visit the Employment Law section of our website at: www.waxmanlaw.com.

We encourage you to pass this Newsletter on to people within your organization, and to your clients and friends.

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⁶ See NY Labor Law Section 191. 1. c., as amended effective October 16, 2007. The Richard H. Waxman, P.C. Employment Law Newsletter on this topic may be accessed at: <http://waxmanlaw.com/wp-content/uploads/2011/01/Commish-Salespeople.pdf>