A Director's Guide to
EXECUTIVE COMPENSATION

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Non-Competition Agreements

Avoid the Enforcement Pitfalls

Non-competition agreements are often part of an executive's terms and conditions of employment. Generally, a non-competition agreement restricts an executive from working for or financing a competitor, or establishing a competing business, within a specified geographic area, while employed and for a period of time afterward. Executives may also be bound by a non-solicitation agreement. Typically, a non-solicitation agreement restricts an executive from soliciting, except as required to carry-out his or her duties, some or all of the employer's customers or suppliers within a specified geographic area, while employed and for a period of time afterward. A non-solicitation agreement also commonly restricts the executive from soliciting the employees of the employer to leave their employment. These types of agreements, which in one way or another restrict an executive's activities, are referred to as restrictive covenants.

Restrictive covenants may be established as stand-alone agreements. Alternatively, they may be included in an employment or severance agreement or any other agreement that provides a benefit to the executive during or after his or her employment.

The following reviews the terms that should be included in restrictive covenants in Canada and the U.S., the differences between commercial and employment agreements, the enforcement procedures, some practical considerations and what occurred when Nortel hired Motorola's former CEO who allegedly breached the non-competition obligations owed to Motorola.

Non-Competition Terms

Employers are often tempted to impose onerous, lengthy and geographically broad non-competition and non-solicitation terms on executives to protect the organization's business. However, courts are loath to enforce burdensome restrictive covenants that impede an individual's ability to earn a living. In fact, courts often start with the presumption that restrictive covenants are unenforceable because they are a

These quarterly newsletters provide practical advice and current legal comments on executive compensation and compensation governance and disclosure. These newsletters will be of interest to directors, executives, lawyers and human resources professionals.

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From the Editor

Non-competition and non-solicitation agreements are among the most litigated terms in employment agreements. When litigation starts, courts need to balance the executive's need to earn a livelihood against a company's need to protect its business. This newsletter outlines what courts consider in deciding on whose side the scales of justice will swing. Commenting on the U.S. perspective are Tex McIver and Deepa Subramanian, attorneys at Fisher & Phillips LL.P. *— Nadine Côté LL.B.*

Don't Let Departing Executives Take Your Business

Comments on the U.S. Perspective from Fisher & Phillips LLP

By Tex McIver and Deepa Subramanian

In today's competitive business environment, organizations are fighting to hold onto their business and customers. This environment elevates the importance of having enforceable non-competition agreements to protect businesses from competition from departing executives. In the U.S., the enforceability of non-competition provisions varies from state to state. Some states, such as California, strongly disfavour non-competition agreements in employment. Other states have enacted legislation permitting post-employment non-competition agreements. Most states permit them subject to varying degrees of judicial scrutiny. The common law rule is that, although such covenants constitute partial restraints of trade, a post-employment restrictive covenant is enforceable if it: (1) relates to a contract of employment; (2) is supported by adequate consideration; (3) is reasonably necessary for the protection of the employer; and (4) is reasonably limited in duration and geographic extent.

In order to have an enforceable non-competition agreement, an employer must have an interest that the restrictive covenant can properly protect. For example, trade secrets or specialized training are generally considered protectable interests, but such interests are assessed on a case-by-case basis. Restrictive covenants can also be used to protect interests in customer relations that have been developed through the efforts of the executive while working for the employer.

Some courts also look for a backwards reaching time limit in assessing the enforceability of these agreements. The non-solicitation clauses in dispute in *Share Corp. v. Momar, Inc.*, 2010 U.S. Dist. LEXIS 22608 (E.D. Wis. Mar. 11, 2010) generally barred sales representatives and sales managers from soliciting chemical sales business for any customers they served or supervised during their employment. The covenant did not limit how far back it would reach in determining which customers they had served or supervised. A customer that the representative served ten years earlier would still be off-limits. Under Wisconsin precedent, this lack of a backward restriction made the restriction unreasonable. The court found no mitigating factors justifying the restriction and denied the applicant's petition finding Share was unlikely to prevail on the merits of its claims.

Timing for Entering Non-Competition Agreements

In terms of timing, an employer need not obtain a non-compete agreement at the inception of employment, although this might be the safest route. A majority of states hold that continued employment without a substantial change in employment position is sufficient consideration for a non-competition agreement. However, some courts will enforce a restrictive covenant executed subsequent to the initial employment only when the employee who restricts himself receives sufficient new consideration — some benefit for the signing of the non-competition agreement. In those states, the mere continuation of employment is not sufficient consideration despite the fact that the employment relationship was terminable at the will of either party. Sufficient consideration will exist, however, if the employer promises continued employment for a definite term or offers a sufficient monetary payment for the signing of the agreement.

Employers are not without protection when departing executives leave and misbehave.

Non-Solicitation Agreements

In states that take a dim view of non-competition agreements, employers may be safer entering into non-solicitation agreements in addition to or in lieu of a non-competition agreement. Non-solicitation agreements can identify the customers the departing executive is barred from soliciting or they can more generally bar the departing executive from soliciting all customers with whom he or she worked. A non-solicitation agreement must be limited in duration and scope.

Enforcement

Before rushing to court to try to enforce non-competition agreements, many lawyers encourage their clients to write a "cease and desist" letter to see if the departing executive and his or her new employer will voluntarily comply with the restrictions. Often, the warning letter will prompt settlement talks between the parties. A negotiated settlement might be an attractive option, particularly if the contractual provisions have flaws that could hinder their enforceability. The cost savings of avoiding a protracted legal battle is another positive factor in securing settlement terms that may be short of a homerun, but still offer sufficient protection.

The main point is that employers are not without protection when departing executives leave and misbehave. With the right agreements and proper protections, employers can prevent departing executives from taking the business with them when they leave.

Thanks to Tex McIver, Partner and Deepa Subramanian, Associate of the Atlanta offices of Fisher & Phillips LL.P, one of the oldest and largest management-side labour and employment law firms in the U.S. They can be reached at tmciver@laborlawyers.com and dsubramanian@laborlawyers.com.

Nortel's High Price for Hiring Motorola's CEO

There is a much publicized case dealing with the hiring of a CEO who was bound by a restrictive covenant with his former employer. On October 18, 2005, Motorola Inc., filed an injunction with the Circuit Court of Cook County, Illinois, to prevent its former CEO, Mike Zafirovski, from joining its then rival, Nortel Networks Corporation. Motorola wanted to stop Zafirovski from working for Nortel for two years, from soliciting Motorola employees and from utilizing or disclosing Motorola's confidential information. In settling the matter out of court, Nortel agreed to reimburse Zafirovski the US$11.5 million owed to Motorola under the settlement. With the benefit of hindsight, merely four years later, with Zafirovski at the helm of Nortel as it obtained bankruptcy protection, one cannot help wonder: did Zafirovski joining Nortel really pose the threat of US$11.5 million in damages to Motorola?[1]

restraint on trade. A heavy onus is then placed on an organization seeking to enforce a restrictive covenant to prove that there is a proprietary interest deserving of protection, the covenant is reasonable in the circumstances and needs to be enforced to protect the organization's interest. The reasonableness of the covenant must be proven on several fronts:

- The geographic scope set out in the agreement must be reasonable
- The timeframe imposed must be reasonable
- The subject matter of the restraint must be reasonable

In order for these limits to be reasonable, they should restrict the individual's ability to earn a living only to the extent necessary to protect organization's interest. If the covenants extend beyond what is necessary to protect the interest of the organization, they will not be enforced by the courts. In particular, courts have noted that a non-competition covenant will not be enforced if a less onerous non-solicitation covenant would have sufficed. Non-competition covenants have been said to be more onerous because they go beyond restricting the executive from soliciting certain customers and extend to keeping the executive out of the business.

Courts also appear to take into consideration the level of the executive in assessing the reasonableness of the covenant, though this has not been expressly acknowledged. Courts seem to recognize that the more senior the executive is or the stronger the executive's customer relationships are, the greater the need to protect the organization's interest by restricting the executive's post-employment activities.

As with any agreement, consideration must be exchanged for the agreement to be enforceable. Consideration is something of value provided to the executive. Consideration for entering into a restrictive covenant can include an offer of employment, a promotion, a pay increase, a grant of equity-based compensation or a signing bonus.

Commercial and Employment Agreements

In deciding whether to enforce restrictive covenants, courts have also considered the context in which the agreement was entered. Courts are more inclined to enforce restrictive covenants that are terms of a commercial agreement, such as an agreement for the purchase and sale of a business; rather than restrictive covenants that are strictly part of an employment agreement. Courts recognize that in the commercial context, restrictive covenants may be necessary for the transaction to be viable. For example, a purchaser paying valuable consideration for a business has a legitimate interest to protect from competition from the seller – the value of the acquisition. Restrictive covenants prohibiting the seller from competing against or soliciting the customers of the business that was sold may be key terms to the transaction. A seller who sold a business, agreed to restrictive covenants and soon thereafter commenced competing may well find itself subject to a court order to cease and desist the competing activities and pay damages.

Enforcement Procedures

When executives leave their employer and breach their post-employment restrictive covenants by competing against or soliciting customers or employees from their former employer, typically, time is of the essence for the former employer. Time is critical because once the damage is done to the former employer's business; it can be very difficult or even impossible to undue. For example, if customers or employees leave to go to the competitor as a result of the departed executive's conduct, it is unlikely they will return. As such, the former employer must act quickly to stop departed executives from further breaches of their restrictive covenants before losing its business, customers or employees.

The former employer can correspond with the departed executive and any subsequent employer to attempt to reach a resolution. However, if corresponding is unsuccessful at halting the misconduct, litigation may be the necessary next step.

Litigation can start with an application for an injunction. Applying for an injunction is a legal process in which an applicant applies to the court on an expedited basis for an order from the court. An applicant can request that the court order a respondent to do or cease doing what the applicant alleges the respondent must do or cease doing, such as an order to cease competing against the applicant in contravention of a non-competition agreement. An injunction may be temporary, interlocutory or permanent.

The ramifications of the court ordering a respondent to do or cease doing something in connection with restrictive covenants can be serious and may effectively end the dispute between the litigants. As such, the court imposes a high threshold on an applicant seeking an injunction. The applicant must prove

that there is a serious issue to be tried at trial; it will suffer irreparable harm unless the court makes the order requested; and, the balance of convenience favours the applicant.

In addition to bringing an injunction, a former employer can commence a lawsuit against the departed executive and any subsequent employer seeking damages caused by the breach of the restrictive covenants. Damages awarded on a breach of contract generally attempt to put the party who suffered the damage in the position the party would have been in had the contract been fulfilled. For example, if an executive breaches his or her non-competition obligation and customers move their business from the former employer to the new competing business due to the executive's misconduct, the court might award damages equal to the value of the business lost for the period of the non-competition agreement. The award would be based on the assumption that had the departed executive complied with the restrictive covenants, the former employer would have continued to benefit from the customer's business for that period of time. As such, the former executive must return the ill-gotten gains from the breach of the restrictive covenant.

Despite the availability of the court proceedings described above, success in court is often difficult to achieve given the courts' reluctance to enforce restrictive covenants, the high threshold for obtaining an order on an injunction and the complexity of proving damages. Moreover, these processes are time consuming and usually very costly in legal fees. Rather than relying on litigation proceedings to enforce restrictive covenants, a practical means of encouraging compliance involves linking future payments to the executive to compliance with the restrictive covenants.

Practical Considerations

Organizations seeking to promote compliance with post-employment restrictive covenants often tie these obligations to the payments and benefits being provided to the departed executive. Executives who fail to comply with their post-employment obligations may suffer a partial or full reduction in the payments and benefits the organization had offered. Executives are often much more apt to comply with post-employment obligations when faced with the risk of losing the payments and benefits offered to them. Providing payments and benefits for the period covered by the restrictive covenant can also help with its enforceability. The restrictive covenant appears more reasonable when the former executive is still provided a means to support his or her living.

Linking post-employment payments and benefits to the executive's obligation to comply with post-employment restrictive covenants can be done in various ways. For example, an executive employment agreement could provide that on a termination without cause, the executive will receive periodic severance payments if the executive complies with his or her restrictive covenants. Another option would be to link any post-employment vesting or exercise of equity-based awards to compliance with the executive's restrictive covenants. The receipt of supplemental pension benefits or retiree health and medical benefits could also be tied to the executive's compliance with post-employment restrictive covenants, depending on the terms of these arrangements.

From a practical perspective, the ability to withhold payments and benefits to a former executive on a breach of his or her restrictive covenants is far easier than commencing legal proceedings to enforce restrictive covenants. Linking the executive's future payments and benefits to the executive's compliance with the restrictive covenants can also have the effect of reversing the onus of proof in the event of a legal dispute. For example, assume an organization discontinued the pay and benefits offered to the executive on the basis the executive breached his or her restrictive covenants. The onus would then be on the executive to commence legal proceedings seeking an order that the organization provide the payments and benefits which had been offered and claim damages for the organization's breach of contract.

In sum, restrictive covenants can be a valuable tool in protecting an organization from departing executives. Care must be taken in drafting and implementing these agreements to improve their chances of enforcement. In addition, organizations can take practical steps to encourage compliance with restrictive covenants, such as linking compliance to post-employment payments and benefits.

[1] Romina Maurino, "Motorola Files Lawsuit Against New Nortel CEO Mike Zafirovski" *Canadian Press Newswire* (19 October 2005); David Patton, "Nortel Networks Heads into 2006 with a New CEO Known as a Hands-on Executive with a Mandate to Boost the Battered Company's Lackluster Profitability and Restore Its Tarnished Image Among Customers and Investors" *Canadian Press Newswire* (22 December 2005).