FAEGRE BAKER DANIELS

How to Lose Friends, Keep Clients and Influence People

A Study of Restrictive Covenants in the UK Financial Services Sector

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EXECUTIVE SUMMARY

Faegre Baker Daniels is pleased to present this report on restrictive covenants in the UK financial services sector following our successful representation of Raymond James and seven financial advisors in the recent case of *Towry EJ Limited –v– Raymond James Investment Services and Others*. This case highlighted the impact that restrictive covenants can have on both employee and client retention and the report below draws out some of the central themes that were considered by the court. We hope that it will provide useful and timely insights into what is becoming an increasingly controversial area.

The report draws on a survey of more than 116 businesses in the UK financial services sector, specially commissioned by the international law firm Faegre Baker Daniels LLP and undertaken by the legal research company Jures. It concerns a particularly contentious area of employment law: the use of restrictive covenants. The survey was conducted over a five-month period with almost half of the respondent companies consisting of 201 or more employees. Industry commentators and leading lawyers and academics in the field of employment law were also interviewed.

We consider the kinds of restrictions that are typically used, how the courts approach those restrictions (including some recent examples), the alternative ways in which companies will try to protect their business interests, and what the future holds for restrictive covenants.

So what did we learn?

- **The Art of Drafting:** To protect its interests, an employer needs to get the drafting of its covenants right at the outset and then keep them under review. Businesses change, as do the roles of key employees, and if the technicalities are not addressed on an ongoing basis, the consequences can be disastrous.

- **The Art of Creativity:** Restrictive covenants are not the only way to tie in your employees. Increasingly the industry has looked to alternative, more creative approaches, such as the use of garden leave clauses and deferred remuneration. With all the creativity in the world, however, restrictive covenants seem here to stay.

- **The Art of Difference:** Different approaches are used in different areas of the sector. Although there is an understandable interest in what others are doing, it is apparent that there is no 'industry standard' when it comes to restricting employees. We get a fascinating insight into how these matters are dealt with 'on the ground,' including some tips and insights from the decision makers.

INTRODUCTION

In the high-octane world of financial services, where entire City businesses can be built on the excellence of one or two high-powered players and the value of their individual relationships with key clients, it is not hard to appreciate the role of well-drafted employment contracts.

With that in mind, it is not surprising that our research reports the widespread use of restrictive covenants in the financial services sector. What will be surprising to some is the application by many companies of a blanket—or 'industry standard'—approach to the inclusion of such clauses within employment contracts.

This reflects a deeper ambivalence within parts of the City about the effectiveness of employment law measures in retaining clients and business following the departure of leading staff. That ambivalence is based on a lack of understanding in certain parts of the financial services industry about the legal framework that surrounds restrictive covenants, and this can have damaging and even disastrous consequences.

Whilst, unsurprisingly, the vast majority of respondents—more than eight out of ten businesses—have restrictive covenants in their contracts of employment, only slightly more than one quarter referred to them as being 'subject to negotiation or amendment.' In other words, most respondents were using an off-the-shelf approach. That is curious, because in the UK—unlike other jurisdictions such as the US, where negotiation at a later stage is commonplace—you only get 'one bite at the cherry' to get them right. If the covenants are defective at the drafting stage, they will be unenforceable and not worth the paper they are written on.

Whilst there are many in the City who might dismiss restrictive covenants, four out of ten respondents (42%) supported the view that breaches and alleged breaches do get challenged in the finance sector. The recent case of *Towry EJ Limited-v-Raymond James Investment Services and Others* serves as a timely reminder of this.

Just fewer than one in five of our City respondents (16%) had brought legal proceedings against an employee or former employee to enforce a restrictive covenant in the past five years, and this is just the tip of the iceberg. Behind the scenes in the boardrooms, terms and alleged breaches are fiercely discussed between employees and their bosses in an attempt to save face and avoid the expense and adverse publicity of litigation.

These are difficult times. The context for this report is a weakening economy and a sharp rise in regulatory burden on the City, with a particular focus on curbing its perceived excesses, most notably bonuses. In this increasingly tough climate, we can expect greater use of restrictive covenants and a more diligent policing of their terms.

RESTRICTIVE COVENANTS AND THE CITY

When it comes to restrictive covenants, the City is split into two camps: those companies that consider them a vital tool and those that dismiss them as unenforceable or irrelevant to their business. We found this divergence of opinion in our survey. One of the most striking findings was that more than four out of ten respondents reported that breaches DO get challenged (*see chart 1*), and almost one in five revealed that they had brought legal proceedings against an employee or former employee to enforce a restrictive covenant in the past five years (*see chart 2*). This is set against the fact that a smaller number of employers (14%) did not use restrictive covenants at all (*see chart 3*).

The issue of restrictive covenants is a headline grabber. For example, one of the most high-profile news stories in the City in 2010 was the court case that concerned 13 interdealer brokers moving from Tullett Prebon to BCG. Tullett accused its rival of spending £40m to entice the brokers to breach their non-compete restrictive covenants and move companies. Tullett won the case. It's not known what settlement was reached, but it was reported Tullett was seeking £350 million. The stakes could hardly have been higher.

The myth of uselessness

Many of those who are dismissive of restrictive covenants seek to apply them to the wrong people, or for the wrong timescales, or simply fail to understand what a useful tool they can be.

More than one third (36%) of respondents said that they had never written to an employee or former employee to remind them of their restrictive covenants or to threaten to enforce them (*see chart 4*). In the financial services sector, where such clauses are often thought to be a fact of life, that is a surprisingly high figure.

Whilst, as mentioned in chart 1, more than 40% of respondents do think that breaches of restrictive covenants are challenged, more than one in four (28%) thought that breaches went unchallenged, and more than one in five (22%) were unsure whether they are challenged or not.

Clearly many people are unconvinced that restrictive covenants are effective tools. Why? The first point to understand is that restrictive covenants are complicated things. They mean different things to people in different sectors and roles; they are treated differently by CEOs and IFAs, by insurers and by interdealer brokers.

CHART 1: Is your view that in the finance sector, breaches of restrictive covenants (including team moves) generally go unchallenged or without recourse to the legal process?

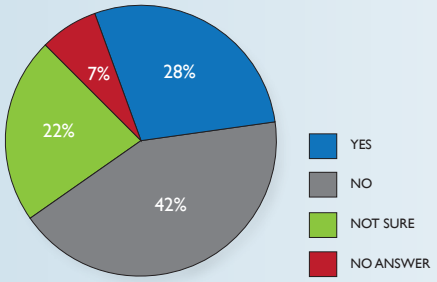


CHART 2: Approximately how many times in the last five years have you brought legal proceedings against an employee or former employee to enforce your restrictive covenants?

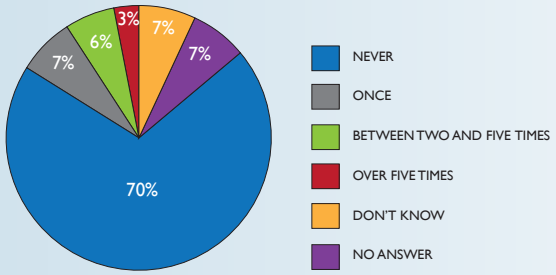


CHART 3: Do you have post-termination restrictive covenants in your contracts of employment?

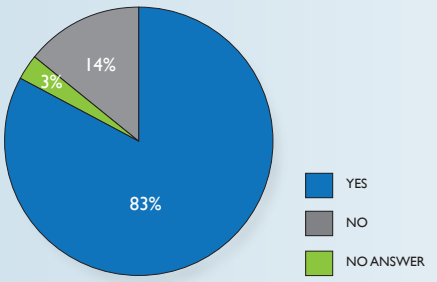
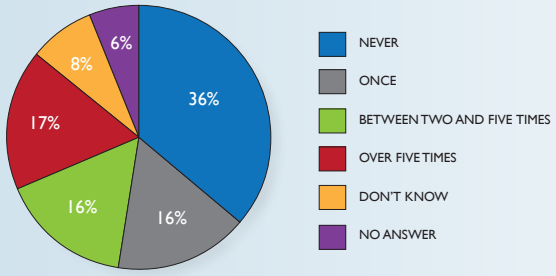


CHART 4: Approximately how many times in the last five years have you written to an employee or former employee to remind them of their restrictive covenants and/or to threaten to enforce them?



DEFINITIONS: WHAT ARE RESTRICTIVE COVENANTS?

A post-termination restrictive covenant is a clause in an individual's employment contract that restricts him from doing certain things after he has left his employer. In order to be enforceable, a restrictive covenant must protect a legitimate business interest and be reasonable in scope and duration.

1. ***Legitimate business interest:*** An employer must consider what aspects of its business legitimately require protection. Generally speaking, the courts will allow an employer to protect the following business interests by means of restrictive covenants: trade connections (for example with clients, customers and suppliers); confidential information; and the stability of its workforce.

2. ***Reasonable scope and duration:*** The restriction must be no wider than is reasonably necessary to protect the business interest. This means that the covenant must be limited in scope and duration. It is particularly important to consider this carefully, as a court will not re-write a covenant if it is too broad; it will only delete parts of a covenant if the remaining words would constitute a valid and enforceable restriction (known as the 'blue pencil' test). The contract would ideally have a well-drafted severability clause which would allow the court to do this. What is reasonable will depend on the type of covenant, the nature of the business and the employee's position within the business, as explained further below.

It's also true that restrictive covenants are taken more seriously in some parts of the City than in others. Much depends on a firm's size and resources. A trial is expensive – £20-30,000 at the lowest end of the scale and up to £1m at the top end – and beyond the means of all but the big companies. Smaller businesses feel that restrictive covenants are not for them. They are also taken more seriously in some sectors than others. Giles Powell, a leading employment barrister from Old Square Chambers, told us that he was recently involved in a case involving investment bankers and summed up their view on restrictive covenants as follows: "provided you don't do anything silly, and don't tell us what you are up to, then we are not too bothered … There is an air of reality to it." He added, "People don't really want to enforce them." Another employment barrister said that there is a "we-are-the-best" attitude at some companies and a feeling that they don't need restrictive covenants because nobody would want to leave.

In many of the more "testosterone-fuelled" sectors—as one respondent called them—a laissez-faire view tends to prevail. Here the view is that restrictive covenants are a restraint of trade and they therefore tend not to be used or enforced. An in-house lawyer at a large bank said that clauses forbidding the solicitation of clients are often ignored. In many walks of City life people "regularly bring clients with them. Trying to restrict that relationship is a waste of time; that's the way the market runs. If we are going to stop them taking the client with them, we would never want to hire anyone ourselves. So the market levels itself out."

Gone gardening

In the insurance sector, restrictive covenants are often seen as ineffective for different reasons. "The nature of the insurance world is geared towards one date in the year—the renewal date—so putting somebody on a restriction for six months, say, is kind of pointless," says Chris Croucher, an insurance-industry headhunter, who has been in the industry for three decades. Strong personal relationships between clients and advisors mean that the business will follow the advisor in, Croucher estimates, 60-75% of cases: "If the client doesn't move straight away, 90% of the companies that have a relationship with the individual will have followed him to his new employer within two to three years." In that case, Croucher says, "You have to ask yourself: How much extra protection would a restriction give us?" Perhaps for this reason, those people we surveyed in the insurance industry tend to rely on long gardening leave clauses of up to 18 months, to ensure that the first renewal date for all that individual's clients is long gone, and the firm has had time to cement a relationship with a new advisor. The view rightly taken by the respondents is that restrictive covenants of 18 months would not be enforceable, although of course there is a serious question mark over whether such a long period of gardening leave would be enforceable either.

Others point out that restrictive covenants can be ineffective because breaches are often hard to detect. "There is no systematic way of finding out," says Dan Stephens, in-house lawyer at accountancy firm Grant Thornton. "We might well hear about isolated breaches via partners. Often the client will be approached and decide to pass the information back to us. If people are crass about it, then you can tell

if clients suddenly say that they are moving in droves to a different firm. Then we will think, 'Who recently went to that firm?' But in isolated cases it is hard to find out." Giles Powell agrees: "A lot of these people have access to the same client lists, and it is hard to establish who brought in what clients."

"Really we are asking people not to take the mickey out of us when they headhunt our staff," says Paul Cann, HR director at Groupama Insurance. "Restrictive covenants are a deterrent really. We don't want people to blatantly poach our staff and then our business. If people are subtle about it, it can be hard to prove; but we would certainly hope that covenants would stop our MD leaving and taking three heads of business with him. At Groupama, we have never taken anyone to court, but we have written letters reminding people of the terms of covenants and have sent letters from our lawyers. These are really a warning shot across the bows."

Busting the myth

However, as Chris Quinn, a leading employment barrister at Littleton Chambers, who was on the winning side in the Raymond James case, says: "Anyone who subscribes to the feeling that restrictive covenants are unenforceable is unfortunately ignorant as to the practice before the courts, because on a daily basis the courts are enforcing restrictive covenants against individuals who do not want to abide by their restrictions. In fact, on an interim basis it is far more likely than not that a court will enforce a restrictive covenant."

There clearly are cases when restrictive covenants do work and are taken seriously. As mentioned above, more than four out of ten of our respondents believe that breaches do get challenged legally, and 16% have brought legal proceedings against an employee or former employee to enforce a restrictive covenant in the past five years. Of those who had pursued breaches, a small number (4%) said that they had done so over five times, although these may have involved team moves (*see chart 2 on p. 5*). Exactly half said that, in the last five years, they had written to an employee or former employee to remind them of their restrictive covenants and/or to threaten to enforce them (*see chart 4 on p. 5)*. We also found that just over one quarter of respondents (26%) said that they would instruct external lawyers to deal with a breach (*see chart 5*).

TYPES OF RESTRICTIVE COVENANT

There are various types of restrictive covenant, but the most common are:

- Non-compete
- Non-solicitation of clients and customers
- Non-solicitation of employees
- Non-deal with clients and customers
- Non-disparagement
- Confidentiality

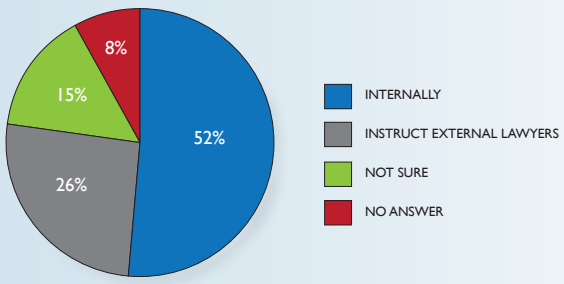
The most difficult covenant to enforce is a **non compete** covenant because the courts view this as the one most obviously in restraint of trade. Typically, therefore, non-compete covenants are shorter than other types of covenant; the key consideration is the length of time it will take for the business to recover and for the ex-employee's competitive activity to be less of a threat to the business. Generally speaking, a non-compete covenant in excess of six months will be difficult to enforce.

Non-solicitation of clients and employees covenants are easier to enforce as they do not usually prevent an employee from finding another job. However, the covenants must be limited to cover only those clients and employees with whom the departing employee had material dealings during a specified period (usually 6-12 months) prior to termination.

A **non-deal with clients** covenant is one way to handle the evidential difficulty in proving that an ex-employee has 'solicited' a client. However, as the scope of a non-deal covenant is wider, a court will be more cautious about upholding it. It has a better chance of being enforceable if the employer can show that there is a substantial personal connection between the ex-employee and the client or customer.

A **confidentiality** restriction is the most common type of post-termination covenant. Some protection is available as a matter of common law (i.e. even in the absence of a written contract), but this is limited to trade secrets, so it is worth including comprehensive express covenants in an employment contract which protect other confidential information too.

CHART 5: If you became aware of an employee or former employee breaching restrictive covenants, would you deal with the matter internally or instruct external lawyers?



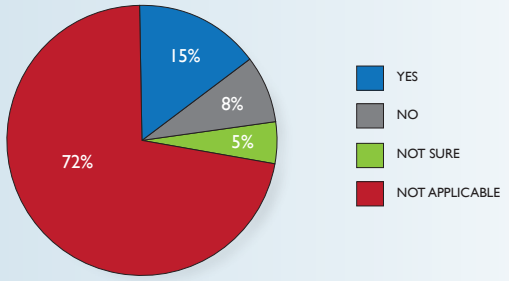
Cross-fire

Historically it has been rare for restrictive covenant cases to actually make it to trial – and only in "10-15% of cases do you get an injunction," estimates David Reade QC, an employment barrister at Littleton Chambers.

But a cross-fire of lawyers' letters is not an uncommon thing. One City headhunter called this "chest-beating," suggesting that it is a show of aggression that is not backed up by any real force. However, the reality is that simply sending a letter can be extremely effective. Dan Stephens, the in-house lawyer at Grant Thornton, says, "I will advise [companies] on whether former employees can approach clients, and have corresponded with the former employees about it." He adds, "you rarely have to go past the point of saying: 'You have been approaching our clients, stop it now.'"

Stephens also deals with the other side of the coin. He says, "People who join us ask us if they can contact former clients, and we have to consider their obligations to their former firm very carefully." Clearly in his industry restrictive covenants are taken seriously.

CHART 6: If you have brought legal proceedings to enforce restrictive covenants, have these proceedings been settled or withdrawn before the court trial?



This shows that those who believe that restrictive covenants are ineffective are wrong. Courts are willing to enforce them, and the implicit threat of legal action gives them power. Indeed, as our survey shows, of the 23% of cases in which lawyers were instructed, more than a third (8%) ended up in court, while 15% settled or were withdrawn before that point (*see chart 6*).

"For us, a restrictive covenant is a very useful tool," says William Wilson, Head of HR at Miller Insurance. "Such covenants are used as leverage to work out the split if someone is leaving the brokerage. We might have a discussion about client movements with the new employer and look for a percentage recovery."

Bernard Murphy, a director at Continuum Insurance Brokers, notes: "We will send solicitors' letters to both ex-employees and their new employers to remind them of the terms of a covenant, but we have never gone further than that. I think you have to take a realistic approach – if someone wants to move on, they will move on."

MISCELLANEOUS LEGAL ISSUES

Terminating in breach of contract

If an employment contract is terminated in breach of contract, then any post-termination restrictions will fall away and no longer be enforceable. This can arise in a "constructive dismissal" situation where the employee resigns in response to a fundamental breach of contract by the employer.

Garden leave

Garden leave is a useful tool for the employer as it effectively serves as a paid non-compete restriction during the employee's notice period, keeping the employee out of the market and away from the company's employees, clients and customers. It is always worth including a garden leave clause in a senior employee's contract, so that the employer has this option. However, given its restrictive nature, courts will generally only allow a limited period of garden leave, typically up to six months.

THE RAYMOND JAMES CASE – HOT OFF THE PRESS

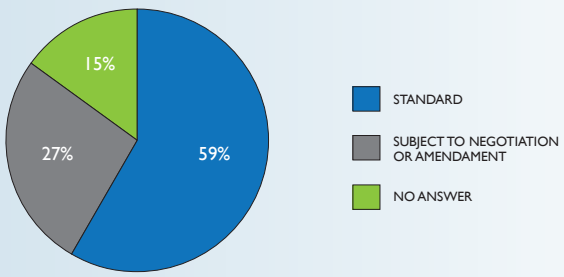
Of course, the safest and best option for employees and their new employer is to comply with any restrictive covenants. The Raymond James case, Judgment in which was handed down on 14 February 2012, is a good example of how to do this.

Raymond James took legal advice before and throughout their recruitment of a number of financial advisers following the acquisition of Edward Jones by Towry Law. They also insisted on their prospective recruits taking independent legal advice on their restrictive covenants. Both Raymond James and the advisers followed the legal advice they were given, and a comprehensive paper trail was put in place by Raymond James to demonstrate its efforts at ensuring compliance with the covenants.

The result was that Towry's claims for breach of contract and conspiracy were thrown out in their entirety. Towry failed to show any evidence of solicitation by the advisers. They also failed to show any evidence of conspiracy or inducement to breach contract by Raymond James.

This case shows that the courts will not be persuaded that a non-solicitation restriction is effectively the same as a non-dealing restriction (as was argued by Towry) and also that a non-solicitation clause on its own will not be sufficient to protect a business where the key relationship is between the employee and the client (rather than the employer and the client) and where the clients are likely to move of their own volition. Towry's case was built entirely on inference, and that in itself will not be enough to evidence solicitation.

CHART 7: Are your restrictive covenants in standard form or are they subject to negotiation or amendment depending on the employee?



"You can possibly stop them contacting clients for a year. We try to make it difficult for the ex-employee and then spend the year working really hard on maintaining the client relationship; but if after that they want to move, it is very hard to stop them," Murphy continues. "If an ex-employee completely ignored our letter, then we would go further. We work to rebuild a relationship with a client. If after a year we lose them, then we lose them."

Some companies will go to extraordinary lengths to discover whether an employee is breaching, or planning to breach, a covenant—and employees will do anything to avoid being discovered. During the *Tullett Prebon* case, it was reported that one employee was asked to hand over his BlackBerry handsets so that the firm could look at the messages he had been sending. He promptly 'lost' seven handsets—and was unable to remember the password of the eighth handset. Unsurprisingly, the judge found him to be an unreliable witness. He said, "I am satisfied that it was Mr Verrier's gambit to 'lose' BlackBerries whenever he thought they might contain inconvenient material, and that his instructions were the cause of at least some of the mobiles being lost." In that case, the restrictive covenant certainly did matter; the employee was believed to have taken extreme measures to conceal his actions because he feared the repercussions of non-compliance.

In other cases, a restrictive covenant can help prevent valued staff from leaving. A lawyer at a very large and well-known City firm told us that it is standard practice to monitor the phone and email of a senior executive if it is thought that he has had his "head turned" by a rival. "There are forensic accountancy and investigation skills that can be applied—most people have mobile phones and emails supplied by the company. There are usually ways to find out if traffic is going on. Beyond that you have to go to specialist investigations people to delve a lot deeper," he said. If the firm does discover that the executive is thinking of leaving, then "at that point the restrictive covenant might become a negotiating tool." The act of covertly monitoring employees does of course throw up other legal issues and problems that would need to be considered in the overall mix.

And if restrictive covenants are going to be used as a bargaining chip, then they have to be fit for purpose—meaning that they must be tailored to the individual employee. Well over half of respondents (59%) told us they had standard restrictive covenants which are not tailored to the individual employee or negotiated (*See chart 7*).

The use of restrictive covenants as part of the kit of negotiating tools is common in some parts of the City. Mark de Ste Croix, Head of Compliance and Legal at financial advisory firm Raymond James, told us: "It's not unusual for people with restrictive covenants who come here to go to their employer and say, 'Let's talk about what happens to the clients.' I've seen deals done where people say that if they keep 50 they will try to persuade the other 150 to stay. There's a bit of give and take." An in-house lawyer at one City bank says, "At the end of somebody's employment, you can sit down with them and consider dropping parts of the restrictive covenant in return for certain other things. In that case, it is important that you have a well-drafted restrictive covenant because, if there is doubt as to whether it's enforceable, then you can't use it as leverage." Small companies should therefore take note: even if the cost of a trial is out of reach, restrictive covenants can still be useful.
Another point to consider here is that restrictive covenants are usually only necessary and effective for key employees. All our sources said that covenants are only worthwhile for the very top staff, or those in industries that are based on personal relationships. And yet our survey shows that a third (34%) of respondents had restrictive covenants for all staff (*see chart 8*).

GET PROTECTED

So what does an employer need to protect itself? One phrase that came up regularly when we spoke to lawyers about restrictive covenants was that they have to be "well-drafted". Whether you plan to use your restrictive covenants to prevent former employees from soliciting clients or staff, or as a negotiating tool, they will be useless if they are not enforceable. For more detail on how to draft enforceable covenants see the box-out on page 7.

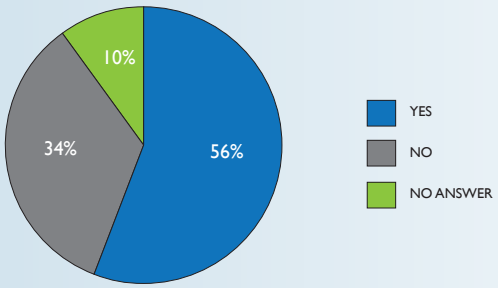
Our survey revealed that a surprising number of City companies appear to have badly drafted restrictive covenants. For example, a small number (3%) had non-solicitation of clients restrictions of more than 12 months; the same number had non-solicitation of employees restrictions for more than 12 months; and 2% had non-compete restrictions of more than 12 months. It is very rare that a non-compete restriction of more than 12 months will be enforceable. Even worse, a number also had the same restrictions without any time limit, which would certainly be unenforceable (*see chart 9 on the next page and question 7 in the Appendix*).

THE END OF LAISSEZ-FAIRE?

As we have seen, there is a strong view in some parts of the City that clients ought to be free to go with advisors when they move from one employer to another. Courts have historically supported this laissez-faire point of view by pushing the "public interest point"; in other words, that customers should be free to engage who they choose. But arguments for the opposite view are strong—and perhaps gaining in strength. A restriction banning the solicitation of clients might seem to violate the laissez-faire view, but "in case law, the courts have taken the view that the restriction is not restraining the client from having a significant choice," says Adam Tolley, a senior employment barrister from Fountain Court Chambers. "They have plenty of choice, they just can't use that one person. In the City this is certainly a persuasive argument, especially when a lot of services are commoditised." He thinks it is possible that companies might become hostile to the laissez-faire view: "They might take the view that if they let the employee take this client today, then others might follow tomorrow." That's important because many high-profile restrictive covenant cases involve one employee leaving and then enticing a team to come with him, which can see a firm potentially losing a whole area of its business, and the profit that comes with it.

If business remains tough, it's possible to imagine an increase in restrictive covenant enforcement. And that could potentially have a big effect on the City employment market. One barrister who wished to remain anonymous said that last year's case between Tullett Prebon and BGC "put a bit of a chill in the interdealer broker marketplace." That is certainly one of those sectors where "chest-beating" and threats of litigation are common, and when the Tullett case went to trial and got "bloody," people became wary, says the barrister, and the market slowed significantly.

CHART 8: Are there any categories of employee (for example, administrative staff) who you would not ask to sign up to restrictive covenants?



REGULATORY CHANGE MEANS RESTRICTIONS MATTER

As the regulatory burden on City firms increases, restrictive covenants will matter more in the future. "We haven't seen the full effect of the FSA remuneration code," comments one employment barrister. "It is generally thought that it will affect bonuses, but nobody is sure how it will work with restraint of trade." If, for example, 'golden hellos' are banned, then pay will increase to compensate, which means firms will be keener to hang on to employees and possibly look to introduce more onerous restrictive covenants.

On the other hand, deferred payment could have the opposite effect. "If you are positively encouraged to have deferred remuneration packages, then you will be less worried about covenants, so the regulation would in itself be a powerful disincentive for somebody to leave the company," he says. How this all plays out remains to be seen.

Miller's William Wilson does not believe in golden handshakes or in binding employees through remuneration: "It may work better in other sectors but generally in insurance, its use is not widespread. The overall effect is to demotivate people, and that does not work for them or the company."

In the insurance sector regulation has already started making restrictive covenants more important. The Retail Distribution Review (RDR), an FSA initiative to bring more regulation into the markets for retail financial products and services, requires insurers to have more qualifications, something which is making it more expensive to run an insurance company. This, say industry insiders, means that insurers are being forced to compete for the higher-value customers who bring in more revenue. "Clients moving with advisors are a massive issue in the IFA market," says Paul Harper, a member of the Executive of the Association of Executive Recruiters, the headhunters' arm of the Recruitment and Employment Confederation. "What's been really noticeable is that historically people have been allowed to take clients when they move employers, but with the introduction of RDR a lot of IFAs are fighting for the same smaller number of clients." Companies which previously would have been happy to let departing staff take some clients with them are being less generous now that business is tougher. They are looking at longer and more severe clauses forbidding the soliciting of customers, and also longer garden leave periods. "They are thinking, 'How do we keep people out of the market?'" says Harper.

He adds that it is a quirk of the industry that IFAs have built up their business by recruiting teams from competitors, who brought clients with them. Traditionally, nobody bothered much with enforcing the non-solicitation of colleagues' covenants. Not anymore. "Now you have to be more careful, and it all hinges on proving who contacted who and when," Harper says.

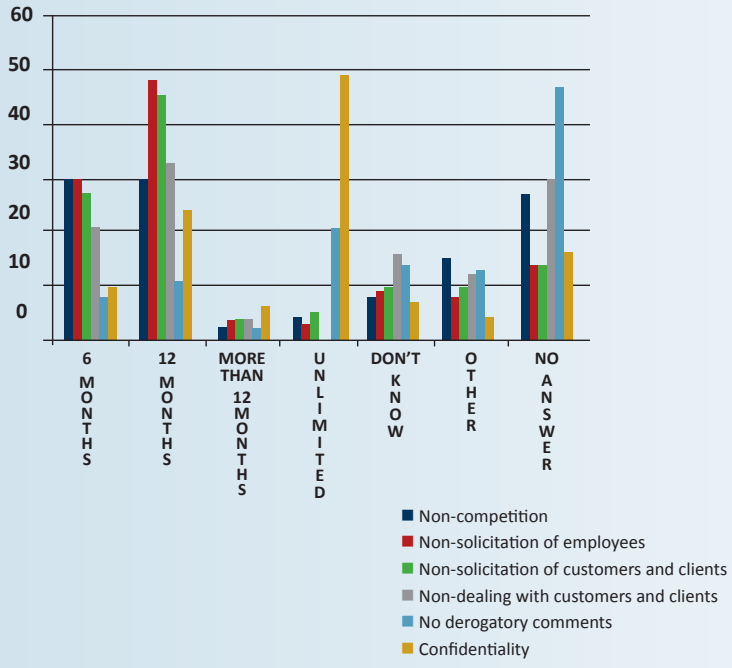
Bad drafting at the outset of the employment relationship is not the only problem with covenants. Barrister Chris Quinn says, "More pressingly, there seems to be a widespread failure to consider reasonableness on an ongoing basis. There can be very important cases that may have the effect of rendering covenants unenforceable; the best thing they can do is to vary the covenants or they will find themselves unprotected. If a one-year restriction is all that a court will enforce, and you have a two-year clause, the court will not reduce it, it will simply reject it."

Restrictions can also cause friction if they are unusual for an industry. Mark de Ste Croix of Raymond James says that when employees join a firm they ought to be made aware of what restrictions they will be under when they leave, especially if they are non-standard for the industry. The same goes for clients, who deserve to be aware that there may be barriers to them following advisors when they leave, further down the line.

For example, for financial advisors a non-dealing clause would be unusual and potentially disruptive for both advisor and client when the advisor moves on, thinks de Ste Croix.

He says, "If there is a non-dealing clause, then the employee and client should be made aware of that when they sign up with the company. At least then everybody knows what they are letting themselves in for. The non-solicitation clause is fairer—and if the employee moves, then the client is free to move with them if they want to and can initiate it."

CHART 9: Please indicate (i) which of these restrictive covenants you use: and (ii) the duration of each post termination of employment (if known).



Are restrictive covenants worth the hassle? The value of restrictive covenants depends, says David Reade QC, on "how much you value the thing you are protecting." So while they are often not necessary for middle management, they are vital for senior management who could take and exploit knowledge of your business and client contacts. It also depends on your sector. He says that "covenants are more likely to be enforced in areas of work where personal relationships are the primary basis of sale." A lawyer at a City bank told us that in such industries people are specifically hired with the intention of soliciting customers, no matter what their restrictive covenant says. "The only reason to hire a partner in a law firm is so he will bring his clients with him," he said, adding that such people will generally insist on a clause in their new contract that says the new firm will pay their fees if they are caught soliciting these clients. In a world where such things happen, the description that another lawyer gave of restrictive covenants rings true: that they are a "risk-management tool."

"I think covenants are the norm for senior people," says Miller's Wilson. "The issue at the end of the day is: are you prepared to have the covenant tested in court? Most of us would rather avoid the huge expense of doing that. Covenants may have some effect and some limited use but they are not a panacea for all ills."

"From our point of view it is all about the clients," says Continuum's Murphy. "We are less concerned about strategy than about losing clients. I think we have a different approach as owners of the business than those who work for other people. We do take a long-term view and work to build for the future. We are less concerned about the immediate results and are not working to achieve certain numbers to impress the owners, and that is reflected in the way we employ people."

GET CREATIVE—ALTERNATIVES TO RESTRICTIVE COVENANTS

Some argue that restrictive covenants are unnecessary, and that other legal options can do the job just as well. There is an increasing trend, especially in banking, to defer an employee's remuneration and then make payment conditional upon non-solicitation and/or non-competition. So, for example, if somebody solicits clients or staff, they may lose part or all of their deferred stock options. What was designed as a carrot to promote loyalty can also be used as a stick to ensure good post-employment behaviour.

Deferred remuneration has been common in the City for years, of course, but as Robin Parkinson, employment lawyer at Santander points out, "In the 'good times' before 2008, new employers tended to buy out the deferred payments. These days that is less common, meaning that the employee has a tangible reason not to irritate an ex-employer. And so deferred remuneration has become a focus for restrictions." As one barrister put it, "The best way to ensure compliance is to hit them where it hurts: in the wallet."

The potential pitfall in using deferred remuneration clauses is that, in the same way as restrictive covenants, they might be seen as a restraint of trade, and there have been cases when the courts have decided that such clauses were overly strict and therefore unenforceable. Courts are more likely to uphold clauses that are designed to encourage loyalty rather than those designed to punish people for bad behaviour, even if they are really designed to do both. Careful drafting of contracts is, as ever, vital.

Another possibility is an **interim injunction**, which can be applied for early on in court proceedings as a holding measure to prevent an employee from doing a particular act until the full trial can be heard – which may take many weeks or even months.

Then, as barrister Giles Powell points out, there are **springboard injunctions**, which aim to prevent the departing employee from getting a boost from confidential information that they have taken from their previous employer. This type of injunction is appropriate where a traditional confidentiality injunction will not suffice because the information has already been disseminated and is therefore no longer

confidential. Before granting a springboard injunction, the court will need evidence that the employee has gained an unfair advantage and evidence of the length of time the advantage will last.

Springboard injunctions can be especially useful in cases of team moves, where a manager may have solicited the members of his old team to follow him to a new employer. If a group of senior people employed by one firm discuss moving en masse to a competitor, they are likely to be in breach of their fiduciary duties, as well as their duty of good faith. As a general principle, courts tend to lean towards allowing people to move and practice their trade, but they may grant a springboard injunction for the length of time that they consider an unfair advantage would last.

Garden leave injunctions, which prevent employees from walking out and failing to honour their notice periods, are another possibility. In these cases, the courts have to decide what length of time it is legitimate to put someone on garden leave and prevent them from working in order to protect their employer's business. That often involves a calculation of how long the employer would need to shore up its relationship with those clients who dealt with the outgoing employee. The court has to strike a balance here between the employee's right to work, and the employer's right to hold employees to contracts that they have freely entered into—often, in the City, for good money. In other words, does high pay mean that people forfeit some of their freedom to move to new jobs? One recruiter told us that garden leave periods of 18 months are strictly enforced in the insurance sector, in the hope that all of an employee's clients will have renewed their contracts before the employee is working again.

Others take a more radical approach: as the starting point for the courts is that all restrictions are potentially in restraint of trade, can it be argued that post-employment restrictions are simply unnecessary? Simon Deakin, professor of law at Cambridge University, points out that under Californian law, post-employment restrictive covenants are not enforceable. "If it works for high-tech, high-velocity labour markets, then can't it work in the City too?" he asks. "They potentially distort what would otherwise be an efficient market."

However, as Chris Quinn, the employment barrister says, "One of the things that persuades companies to pay top dollar for individuals is the fact that they are building into their contracts of employment restrictions that have a value. If I am a bank employing an individual and I know that he cannot compete with me for 12 months after he leaves, then I am more likely to pay top dollar."

WHO OWNS THE CLIENT?

One of the lessons in the Raymond James case is that a non-solicitation restriction on its own will give little protection to the former employer where the adviser has strong relationships with their clients and the clients want to follow the adviser wherever they go. It seems an obvious point but if an employer wants to stop its employees from dealing with their clients, it needs to have a properly drafted "non-dealing" restriction.

The courts have recognised that an employer's client connections are worthy of protection through the use of restrictive covenants. This would extend to non-dealing clauses which prevent the departing employee from dealing with their clients or customers for a limited period after they leave. Whilst this is settled employment law, there are clearly regulatory issues here around a client's freedom of choice. In other words, just because an employment contract prevents an adviser from dealing with their clients, why should this supersede the right of the client to decide which adviser they want to use? It will be interesting to see what, if anything, the FSA does to address the inherent conflict between the interests of the employer (as typically recorded in the employment contract) and the interests of the client in a more robust way than it has done to date.

Arguably, non-dealing restrictions already fall foul of the FSA's rules on treating customers fairly (TCF). It may also be that the courts will take a more restrictive approach to non-dealing clauses than they have previously. For example, they could take the position that where the employer has little or no investment or relationship with the client, it has no legitimate business interest to protect with respect to that client and therefore no right to impose a non-dealing restriction.

This is clearly a hot topic in the financial services sector and Raymond James is leading the charge in seeking an industry agreed protocol on restrictive covenants in IFA contracts to enable clients to be free to deal with whoever they like. The Tax Incentivised Saving Association (TISA) is establishing an executive committee with reprensentation from across the industry which will aim to achieve industry consensus on restrictive covenants. The precedent for an industry consensus comes from the US where some 260 groups, now adhere to a set of basic principles: when an adviser leaves, the client is informed and handed his or her new contact details. The client is then free to leave if it desires to do so. This "client-centric" approach is gaining momentum in the UK.

FINAL THOUGHTS

Restrictive covenants certainly have their drawbacks. They can be extremely expensive to enforce and, if they are not carefully drafted, will have no legal benefit. Some enlightened employers even take the view that they are better off without covenants. If a client wants to move, what is the point of trying to stop them? Going to court to prevent the inevitable from happening, and embroiling the unwilling client in protracted litigation, doesn't sound like good business sense. That said, the courts have shown themselves increasingly willing to enforce covenants where these are necessary to protect a legitimate business interest of the former employer. And even if you don't get to court, they are often a useful bargaining chip when it comes to negotiating with a departing employee. Our view then is that these restrictions are here to stay—you may lose friends by enforcing them, but if your drafting is right, you'll get to keep clients and,who knows, you might even influence people.

ABOUT THE REPORT

This study was commissioned by Faegre Baker Daniels and undertaken by the legal research company Jures to consider the use of restrictive covenants in the UK financial services industry.

ABOUT FAEGRE BAKER DANIELS LLP

Faegre Baker Daniels LLP—the result of a combination between Faegre & Benson and Baker & Daniels on 1 Jan, 2012—offers a full complement of legal services to clients ranging from emerging enterprises to multinational companies. The firm's 800-plus legal and consulting professionals handle complex transactions and litigation matters throughout the United States, Europe and Asia. With offices in Beijing, Colorado, Illinois, Indiana, Iowa, London, Minnesota, Shanghai and Washington, D.C., Faegre Baker Daniels is one of the 75 largest law firms in the U.S. In the United Kingdom, Faegre Baker Daniels LLP focuses on advising middle market and high-quality emerging companies, meeting their legal needs, both domestically and internationally, in corporate finance, mergers and acquisitions, dispute resolution, employment, commerce and technology and commercial property. For more information, please visit *www.FaegreBD.com*. FaegreBD Consulting, the firm's national advisory and advocacy division, is focused on providing services to key sectors of the economy and is based in Washington, D.C. For more information, visit *www.FaegreBDC.com*.

For further details about this report or about Faegre Baker Daniels's restrictive covenants work please contact Alex Denny, Head of our London Employment Group on +44 (0) 20 7450 4568 or at *alex.denny@FaegreBD.com*.

ABOUT JURES

Jures is an independent research company dedicated to the legal services market. It combines expertise from a number of different disciplines: journalism, research, PR and communications, as well as publishing in both traditional and new media. The people behind Jures are the journalist Jon Robins and Gus Sellitto and Richard Elsen, directors of the legal PR specialists the Byfield Consultancy (*www.byfieldconsultancy.com*).

The idea behind Jures is to become a leading source of considered, independent-minded and thought-provoking commentary on the law in a way that informs and influences debate within the profession and beyond.

APPENDIX: METHODOLOGY

A total of 116 companies responded to an online survey of multiple choice questions. The research was carried out over a five month period (July – December 2011) and followed up with more in-depth telephone interviews with a number of the respondents and other industry commentators.

The survey questions are detailed below

Note on percentages: percentages do not always add up to 100% as responses to individual questions were rounded up to the nearest whole number.

QUESTION ONE:

What sector best describes your business?

ANSWER OPTIONS	RESPONSE PERCENT	RESPONSE COUNT
Banking	13.8%	16
Broking	4.3%	5
Fund management	6.9%	8
IFA	19.8%	23
Insurance	29.3%	34
Accountancy	2.6%	3
Other (please specify)	23.3%	27
	answered question	**116**
	skipped question	**0**

QUESTION TWO:

What job title best describes your position?

ANSWER OPTIONS	RESPONSE PERCENT	RESPONSE COUNT
Senior management	41.4%	48
In-house counsel	25.9%	30
HR	12.9%	15
Company Secretary	2.6%	3
Finance Director	0.0%	0
Other (please specify)	17.2%	20
	answered question	**116**
	skipped question	**0**

QUESTION THREE:

How many staff does your business have?

ANSWER OPTIONS	RESPONSE PERCENT	RESPONSE COUNT
1-49	37.9%	44
50-100	6.9%	8
101-200	6.9%	8
201 and above	48.3%	56
	answered question	**116**
	skipped question	**0**

QUESTION FOUR:

Do you have post-termination restrictive covenants in your contracts of employment?

ANSWER OPTIONS	RESPONSE PERCENT	RESPONSE COUNT
yes	82.8%	96
no	13.8%	16
no answer	3.4%	4
	answered question	**116**
	skipped question	**0**

QUESTION FIVE:

Are there any categories of employee (for example, administrative staff) who you would not ask to sign up to restrictive covenants?

ANSWER OPTIONS	RESPONSE PERCENT	RESPONSE COUNT
yes	56.0%	65
no	33.6%	39
no answer	10.3%	12
	answered question	**116**
	skipped question	**0**

QUESTION SIX:

Are your restrictive covenants in standard form or are they subject to negotiation or amendment depending on the employee?

ANSWER OPTIONS	RESPONSE PERCENT	RESPONSE COUNT
standard	58.6%	68
subject to negotiation or amendment	26.7%	31
no answer	14.7%	17
	answered question	**116**
	skipped question	**0**

QUESTION SEVEN:

Please indicate (i) which of these restrictive covenants you use; and (ii) the duration of each post termination of employment (if known).

RESTRICTIVE COVENANTS

Please indicate (i) which of these restrictive covenants you use; and (ii) the duration of each post termination of employment (if known)

ANSWER OPTIONS	6 MONTHS	12 MONTHS	MORE THAN 12 MONTHS	UNLIMITED	DON'T KNOW	0THER*	NO ANSWER	RESPONSE COUNT
Non-competition	30 (25.9%)	30 (25.9%)	2 (1.7%)	4 (3.4%)	8 6.9%)	15 (12.9%)	27 (23.3%)	116
Non-solicitation of employees	30 (25.9%)	48 (41.4%)	4 (3.4%)	3 (2.5%)	9 (7.8%)	8 (6.9%)	14 (12.1%)	116
Non-solicitation of customers and clients	27 (23.3%)	46 (39.7%)	4 (3.4%)	5 (4.3%)	10 (8.6%)	10 (8.6%)	14 (12.1%)	116
Non-dealing with customers and clients	21 (18.1%)	33 (28.4%)	4 (3.4%)	0	16 (13.8%)	12 (10.3%)	30 (25.9%)	116
No derogatory comments	8 (6.9%)	11 (9.5%)	2 (1.7%)	21 (18.1%)	14 (12.1%)	13 (11.2%)	47 (40.5%)	116
Confidentiality	10 (8.6%)	24 (20.7%)	6 (5.2%)	49 (42.2%)	7 (6%)	4 (3.4%)	16 (13.8%)	116
							answered question	**116**
							skipped question	**0**

QUESTION EIGHT:

Approximately how many times in the last five years have you written to an employee or former employee to remind them of their restrictive covenants and/or to threaten to enforce them?

ANSWER OPTIONS	RESPONSE PERCENT	RESPONSE COUNT
never	36.2%	42
once	16.4%	19
between two and five times	16.4%	19
over five times	17.2%	20
don't know	7.8%	9
no answer	6.0%	7
	answered question	**116**
	skipped question	**0**

QUESTION NINE:

Approximately how many times in the last five years have you brought legal proceedings against an employee or former employee to enforce your restrictive covenants?

ANSWER OPTIONS	RESPONSE PERCENT	RESPONSE COUNT
never	69.8%	81
once	6.9%	8
between two and five times	6.0%	7
over five times	3.4%	4
don't know	6.9%	8
no answer	6.9%	8
	answered question	**116**
	skipped question	**0**

QUESTION TEN:

If you have brought legal proceedings to enforce restrictive covenants, have these proceedings been settled or withdrawn before the court trial?

ANSWER OPTIONS	RESPONSE PERCENT	RESPONSE COUNT
yes	14.7%	17
no	7.8%	9
not sure	5.2%	6
not applicable	72.4%	84
	answered question	**116**
	skipped question	**0**

QUESTION ELEVEN:

If you became aware of an employee or former employee breaching restrictive covenants, would you deal with the matter internally or instruct external lawyers?

ANSWER OPTIONS	RESPONSE PERCENT	RESPONSE COUNT
internally	51.7%	60
instruct external lawyers	25.9%	30
not sure	14.7%	17
no answer	7.8%	9
	answered question	**116**
	skipped question	**0**

QUESTION TWELVE:

Have you ever taken legal advice on your restrictive covenants?

ANSWER OPTIONS	RESPONSE PERCENT	RESPONSE COUNT
yes	63.8%	74
no	25.9%	30
not sure	5.2%	6
no answer	5.2%	6
	answered question	**116**
	skipped question	**0**

QUESTION THIRTEEN:

Is your view that in the finance sector, breaches of restrictive covenants (including team moves) generally go unchallenged or without recourse to the legal process?

ANSWER OPTIONS	RESPONSE PERCENT	RESPONSE COUNT
yes	28.4%	33
no	42.2%	49
not sure	22.4%	26
no answer	6.9%	8
	answered question	**116**
	skipped question	**0**

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