TURCAN CONNELL

Briefing Note

Restrictive Covenants

Clauses in contracts which purport to prevent people from working and earning a living are often referred to as restrictive covenants. Whether or not a restrictive covenant is enforceable will depend upon whether it is reasonable in the circumstances to restrict competition. Broadly speaking restrictive covenants can be found in two different types of document.

The first type of document is a contract of employment and sometimes its mirror reflection, a Compromise Agreement. The second type of agreement is a contract for the sale of shares or alternatively a share options agreement.

The law largely depends upon the type of contract the restrictive covenant is contained in. Contracts which have the effect of preventing an employee from working in their chosen field post-termination of their employment will be looked at slightly differently from, for example, a contract for the sale of the business whereby the seller in return for receiving the sale price agrees not to compete with the new business for a period in the future. In the latter case the restrictive covenant is regarded as being part of an at arm's length business deal between consenting business people and necessary to protect the investment of the purchaser. It is easy to see how unfair it would be if a purchaser in good faith and in reliance upon restrictive covenants spends several millions buying a business only to discover that the seller is able to undermine the purchaser's investment in that business by opening up a competing business next door.

The law is slightly more protective of employees. As a general rule the courts will enforce restrictive covenants so long as they are necessary for the legitimate protection of the employer's business. A restrictive covenant which goes beyond what is necessary for the legitimate protection of an employer's business will not be enforceable.

The courts will uphold geographical restrictions, so long as it is reasonable to do so. For example, a restrictive covenant in a butcher's employment contract which prevents that butcher from being employed as a butcher anywhere in Edinburgh would probably not be regarded as reasonable. The business of a butcher tends to be local and preventing the ex-employee from working anywhere in Edinburgh might be said to go beyond what is reasonably necessary to protect the employer's business.

On the other hand, it might be reasonable for a large UK bank to prevent a senior executive from working in certain banking related sectors within the UK post-termination, on the basis that the business is national and therefore the protection has to be national.

Before seeking to impose a geographical restriction it is advisable to spend some time examining the nature of the business and the extent to which it has a geographical base.

The question may arise as to how long should a restrictive covenant should last. There is no straightforward answer to this other than to say that a time period which is so excessive that it cannot be said to be necessary for the legitimate protection of the employer's business will not be enforceable. We have seen restrictive covenants of six months, 12 months and even three years' duration - there is no norm. The longer the period the more difficult it might be to meet the test.

Employees should make an effort when they accept a position to check what restrictive covenants, if any, will be applied to them. We need nowadays to be realistic about the duration of employment at a senior level. Whilst there are many examples of main board directors remaining on the board for many years, the average, particularly with Chief Executives, is probably less than five years. It is therefore not unreasonable for a senior person accepting a senior post to want to know what the effect of this employment is going to be upon his future career prospects if the employment is terminated for any reason. It is also worth checking not just whether there are restrictive covenants but where these might be contained. Often they are contained in the Long-Term Incentive Plan (LTIP) or other share option agreement. There is usually a financial penalty for not complying in the sense that the employee's status as a Good Leaver may change to that of Bad Leaver in the event of the employee taking up a vested position.