

Empty hallways: don't let your business lose clients to departing staff

Legal restraints can prevent your practice from being raided by former employees.

PETER SARDELIC reveals how principals can protect their business.



In an earlier column I discussed the methods by which employers can protect their client base from ex-employees ('Put a stop to ex-employees stealing your client', *MM*, February 24, 2005). The main methods involved protecting confidential information and restraint of trade clauses in the form of client non-solicitation clauses.

In this article, we will look at the practicalities of structuring a restraint of trade clause in an employment contract.

Case study

John has decided to leave ABC, where he has faithfully served ABC Financial Planning for seven years, having joined when ABC was barely a business, and just a spin off from ABC Accounting.

John helped build the business into a highly profitable and valuable financial planning business, and has been respon-

introduced to him through internal referrals. It has been suggested that John become a part-owner for some time, yet John expected to be given his shareholding for free.

Now John has told them that he intends to commence his own financial planning business.

This experience has made ABC realise how poorly protected they were. There are

Non-solicitation clauses

Structuring a restraint clause involves two issues. First, the clause needs to be structured so that it achieves the employer's objectives. The second issue relates to determining how the employer can defend the clause as being legitimate and enforceable.

In a personal services business such as financial planning, the employers' client base is usually

leave, they should be prohibited from attempting to win the business of ABC's clients. ABC's justification is that John, like other employee planners, did not bring any clients to the business. All John's clients were referred to him through internal referrals.

Consistent with this policy, ABC wishes to introduce a standard clause in its employment contracts that, in effect, prohibits employees post-employment from servicing any actual or prospective client of ABC for a period of twelve months (these clauses are also referred to as "non-solicitation clauses").



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Legal principles

Is ABC in a position to defend this clause? There are a number of important legal principles.

First, the employer bears the onus of proving to the court that a restraint clause goes no further than what is reasonably necessary to protect its legitimate interests.

Although in a professional services business an employer's client base is usually accepted as a legitimate business interest, non-solicitation prohibitions on

employees, such as the one which ABC wishes to use, may only prohibit the employee from contacting clients in relation to which the employee has a special connection or potential to influence.

Therefore, it is unlikely that there are ever circumstances where a court would enforce a prohibition that covers clients with whom the employee had no direct dealings.

In determining what is a reasonable non-solicitation period, generally the court will only give

sible for managing and developing half the client base.

The owners of ABC, Adam and Bill, are annoyed with John's decision. John had no financial planning experience or client base before joining ABC, and was trained at ABC's cost. Most of John's clients were

doubts regarding the enforceability of the restraint provisions that John agreed to in his employment contract. ABC now wants to take a fresh look at the restraint provisions used in its employment contracts to introduce effective measures to protect its client base.

accepted by the courts as a legitimate business interest that should be protected by prohibiting former employees from soliciting clients.

What are ABC's objectives? ABC wishes to adopt a 'strict non-poaching' policy in relation to clients. When employees

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the employer enough time to find a replacement employee and to allow that new employee to demonstrate their effectiveness to their clients.

For this reason, the regularity or frequency of client contact is an important factor that poten-

months. The question of what should be the duration of a restraint is based on what is reasonable and necessary to protect an employer's legitimate interests.

Determining an appropriate length of time is not an easy

or herself with the client formerly serviced by the employee" (Craig Roberts v L Quay Futures Brokers).

In this case, which involved a futures broker who serviced retail clients in executing trading transactions and providing

Services Licence (AFSL). As a result, the holder of the AFSL in effect owns the client.

If John is an authorised representative of ABC's AFSL, then the issue of client ownership should have been addressed in any agreement between the AFSL and John.

In this way, John and the other ABC employees will have in place non-solicitation obligations which compliment and support the non-solicitation obligations in their employment contracts.

Conclusions

Employers should carefully review restraint provisions in their employment contracts. They should consider them carefully to see whether they are too long, too short or too wide.

Importantly, they need to consider whether they have suf-

ficient evidence to enable them, if necessary, to show a court that they are reasonable and necessary to protect the employer's legitimate interests in its client base.

Remember, the starting point with restraint provisions is that they are not enforceable against employees. It is up to the employer to persuade the court that they have a legitimate, reasonable and valid restraint clause. Not surprisingly, the Law Courts are filled with cases where employers have not been able to succeed in enforcing restraints.

With appropriate preparation, effort and care, a valid restraint clause can be prepared and this, perhaps, will avoid the need to go to court.

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tially can be used to justify a long restraint period.

To deal with the situation that existed between ABC and John, the client protection clause should safely cover any client with whom John had a direct involvement or where John was still in a position to influence the client. Clients serviced by John would clearly fall within this area, given that John was the only person with whom the client had contact.

However, ABC clients not serviced by John, or no longer serviced by him, are more difficult to justify. The courts have continuously had problems with justifying prohibitions that cover clients with whom the employee had little or no direct dealings because simply they are outside the employee's sphere of influence.

ABC should consider limiting the prohibition to clients that had dealings with the employee at the time of termination and perhaps also a period prior to termination, for example, 12 months.

Restraint time frames

The duration of the prohibition proposed by ABC is 12

issue to decide. Often the courts have decided that restraint periods are too long and are not enforceable as the employer was not able to convince the court that it was both reasonable and necessary.

In ABC's case, the regularity or frequency of client contact is an important factor to be used to justify a long restraint period. ABC may be able to show that it does not have any real direct contact with John's clients, John being the sole connection between ABC and the client.

If the client's contact with his financial planner is quite infrequent, such as an annual meeting to revise a financial plan, this may help ABC in arguing that a long restraint period is necessary.

By distinction, if the employee has frequent client contact a long period is not as easy to justify. As the NSW Supreme Court said in a recent case, the primary purpose of a non-solicitation clause is to enable the employer to "put someone else in the shoes and position of the employee and to put that person in a position to ingratiate him

other services such as research, the court took the view that a period of six months was excessive. Properly structured, financial planning businesses should be able to justify significantly longer restraint provisions because of the infrequent and irregular contact with clients.

Dealer agreements

ABC should consider its dealer representative agreements to see whether they can back up and support the proposed non-solicitation protection. Financial services reform has brought about the need to rewrite dealer/representative agreements and this has required businesses like ABC to deal directly with the issue of client ownership with their dealer.

The reason for this is that unless the dealer/representative agreement deals with this issue of client ownership clearly and completely, then the position under the Corporations Act will, by default, apply. Under current law, authorised representatives such as ABC conduct their businesses "on behalf of" the holder of the Australian Financial

Restraint clause – an example

This clause is quite a good starting point and deals with some of the issues discussed:

"The employer has invested a substantial amount of time and effort to develop business relationships with its clients. To protect the employer's goodwill, you agree that you will not (directly or indirectly) for a period of [INSERT] months after termination (including resignation) of your employment, on your own account or for any other person, firm, company or business:

- (1) provide financial products advice to any client without the prior written consent of the employer; or*
- (2) solicit, entice away, interfere with or endeavour to solicit, entice away or interfere with any client; or*
- (3) employ, engage, solicit or entice away or endeavour to employ, engage, solicit or entice away from the employer any key employee of the employer."*

"Client" for the purpose of this clause means any person, firm, corporation or entity which was or is a client or customer of the employer (or any associated company of the employer) and with whom you have had direct dealings in the period of 12 months prior to the termination of your employment with the employer.

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