D&G Legal Development Alert: Employment

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NY COURT ENFORCES RESTRICTIVE COVENANT AND LIQUIDATED DAMAGES

Although restrictive covenant litigation has become more common in recent years, appellate court decisions that shed light on the parameters of enforceable restrictive covenants are few and far between. In a decision that should guide lower court judges in addressing restrictive covenant cases filed in Manhattan, the NY Appellate Division, First Department, in *Weiser LLP v. Coopersmith* recently overturned a lower court decision that had found a covenant not to compete to be unenforceable. The facts and decisions in the case are illustrative of the Appellate Division's position regarding restrictive covenants.

The defendants in this case were three former partners of Weiser LLP, an accounting firm, who had executed a merger agreement in 1999 when their prior firm was acquired by Weiser. The merger agreement included an exchange of two of the former partners' minority ownership interests (2% for one defendant, 1.6% for another, and the third became a partner after the merger) in their prior firm for interests in Weiser. In addition to the merger agreement, the former partners signed the Weiser Partnership Agreement (WPA), which included a restrictive covenant and a liquidated damages provision. The liquidated damages provision was 100% of the production, not profits, for each client taken to the new firm, for the 12-month period preceding the partner's departure. In April, 2005, the defendants gave notice of their withdrawal from the firm and stated that they would be keeping clients they had brought to the firm, clients referred to them by these clients, and clients from referral services utilized prior to the date of the merger.

The lower court held that the restrictive covenants were unenforceable because they were not reasonably necessary to protect a legitimate interest. The court noted that customer relationships that an employee created and maintained in the course of employment for an accounting firm may be a legitimate interest worth protecting, but in this case, Weiser had neither originated the relationships nor proved that it had played any part in maintaining the customer's relationship with the former partners. The liquidated damages clause was not discussed in the lower-court opinion.

The Appellate Division disagreed and remanded the matter for further proceedings. It concluded that the restrictive covenant was ancillary to the merger agreement and was reasonable in protecting the assets and goodwill Weiser had acquired from the merger. The Appellate Division specifically noted that the WPA was explicitly mentioned in the merger agreement and the covenants should be reviewed under the sale-of-business rule of reason, even though the former partners held only a minority interest. The court also held, without discussion, that the restrictive covenants were nevertheless enforceable under the more stringent test for employment-based restrictions. In addition, the Appellate Division held, without discussion, that the liquidated damages amount (which was not specified in the lower court or appellate opinion) was a reasonable measure of anticipated harm since it was tied to what an arm's length purchaser would have paid for a lost client account as a firm asset in a sale of the business.

Why This Case Matters To You

This case is important because it serves as precedent that restrictive covenants entered into by small minority interest holders in connection with a transaction should be examined under the more favorable sale-of-business criteria. It also serves as precedent for the enforceability of a liquidated damages provision associated with a client-based restrictive covenant, and perhaps more importantly, liquidated damages based on revenue, not profits. Finally, although little discussion was provided by the Appellate Division, this case indicates that the intermediate New York courts may not always stick to the NY Court of Appeals pronouncement in *BDO Seidman v. Hirshberg.* In *BDO Seidman*, the Court of Appeals held that client relationships are only protectable with regard to those relationships acquired by the former employee during the course of his or her employment with the company seeking to enforce the restriction. In *Weiser*, however, the intermediate court seemed to allow the restriction to extend to those clients that the defendants brought with them to Weiser.

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