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Nonsolicitation Agreements

Why a Non-Solicitation Provision May Not Protect You from Losing Customers (and What You Can Do About It)

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Business is about customers. Significant time and money is spent by a potential purchaser of a business investigating the size, profitability, reliability and retention of the seller's customer base. At the closing, the purchaser acquires "good will," which includes the seller's customers. Thus, New York law has long recognized that the seller of a business has a "duty to refrain from soliciting former customers."[1] But is an implied (or express) non-solicitation covenant alone sufficient to prevent the seller from taking the customers with him to another venture? As a recent New York Court of Appeals case makes clear, the answer is no.

Not All Contact Is Improper Solicitation

In *Bessemer Trust Co., N.A. v. Branin*,[2] the United States Court of Appeals for the Second Circuit certified the following question to the New York State Court of Appeals: "What degree of participation in a new employer's solicitation of a former employer's client by a voluntary seller of that client's good will constitutes improper solicitation?" The Second Circuit specifically inquired whether either of the following scenarios would constitute "improper solicitation" under New York law:

1. The active development and participation by the seller, in response to inquiries from a former client whose good will the seller has voluntarily sold to a third party, of a plan whereby others at the seller's new company solicit a client; and
2. Participation by the seller in solicitation meetings where the seller's role is largely passive.[3]

In brief, the defendant sold his investment firm, including the firm's good will, to the plaintiff firm. The purchase agreement did not contain any "non-compete" restrictions. The defendant remained in the plaintiff's employ for another year. Eventually, the defendant became unhappy with his new role because the plaintiff reduced his responsibilities and excluded him from key management meetings, and ultimately, the defendant resigned to join a competitor. Prior to his resignation, the defendant did everything "right": he provided the plaintiff with notice of his intention to leave, assisted in transitioning his clients to other investment managers at the plaintiff firm, and did not inform any of the clients that he was leaving the firm. The plaintiff then notified the defendant's prior clients that the defendant was resigning "to pursue other career opportunities."[4]

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However, once the defendant was hired by a competitor, his prior clients initiated contact with him, with many asking the defendant why he left the plaintiff firm. The defendant's "standard response" was that his new firm "was more appropriate for me . . . that the method of dealing with clients, that the approach whereby portfolio managers managed the client portfolios and interacted directly with the clients was more . . . appropriate for my training and experience of 30 years in the business." Several of the defendant's former clients elected to transfer their accounts from the plaintiff firm to the defendant's new employer. The largest former client (Palmer) went so far as to request a meeting with the defendant's new company, and the defendant prepared his colleagues on Palmer's investment philosophy and attended the meeting with Palmer. The defendant confirmed for Palmer that he would be in charge of their accounts if they were transferred to his new employer and that his new company would charge the same fees as his former employer. After this meeting, Palmer transferred the accounts.[5]

The New York Court of Appeals effectively punted on the issue, refusing to declare a bright line test of what is–and what is not–solicitation. The court recognized that a seller of a business has an "implied covenant" (which some purchase agreements make explicit) not to solicit former customers and that such covenant is "a permanent one that is not subject to divestiture upon the passage of a reasonable period of time."[6] The court then acknowledged that, notwithstanding this covenant, a purchaser assumes certain risks when he purchases an existing business and attempts to transfer the loyalties/good will, including that customers have the right to take their patronage elsewhere.[7]

The court, stating the obvious, held that where the seller, following the sale of his business, initiates contact with his former customers, he has violated the non-solicitation covenant. This is well established law in New York,[8] and thus, the seller may not send targeted mailings or make individualized telephone calls to his former customers informing them of his new business. But this does not completely protect the purchaser of the business, as the seller may engage in general advertising of his new business venture, so long as it is not specifically aimed at the seller's former customer.[9] Of course, if the seller is smart, he will advertise in publications which his former customers are likely to see, and thus effectively circumvent the court's prohibition by inciting the former customers to initiate contact.

Accordingly, the key concern of both the purchaser and the seller should be what happens when a former customer initiates contact with the seller at his new business. On this point, the court is vague, stating that the seller "is not free to tout his new business venture simply because a former client has fortuitously communicated with him first."[10] However, the Court goes on to hold that "not all discussions between a seller and former client are impermissible. While the 'implied covenant' places certain barriers on a seller's conduct, it in no way prohibits a former customer or client from gathering information about that seller. In the free market, consumers of goods and services have the right to make informed choices."[11]

The court held that it is appropriate in the financial services industry for the seller at his new venture to answer a former customer's questions regarding investment strategy, resources available to the seller, personnel, and fee structure, "so long as such responses do not go beyond the scope of the specific information sought." The seller cannot–even where the former customer initiates contact–disparage the purchaser or his business. Still, the *Bessemer Trust* court did permit the seller to disclose to his new employer information about the former client, such as the former client's investment preferences, financial goals and tolerance of risk, but not information (which the court did not identify) that is proprietary to a purchaser of good will. The seller may aid his new employer in making a sales pitch at a meeting requested by the former client and may be present at that meeting to address "factual matters" only.[12] Thus, the court concluded that:

> the "implied covenant" bars a seller of "good will" from improperly soliciting his former clients. We conclude that, while a seller may not contact his former clients directly, he may "in response to inquiries" made on a former client's own initiative, answer factual questions. Furthermore, under the circumstances where a client exercising due diligence requests further information, a seller may assist his new employer in the "active development . . . of a plan" to respond to that client's inquiries. Should that plan result in a meeting with a client, a seller's "largely passive" role at such meeting does not constitute improper solicitation in violation of the "implied covenant." As such a seller or his new employer may then accept the trade of a former client.[13]

Sellers Will Circumvent Any Express or Implied Non-Solicitation Covenant

The Court of Appeals has, as a practical matter, left a hole in non-solicitation covenants that a smart seller could drive a truck through. Of course, the seller cannot initiate contact with his former customers. But the seller can–and will–advertise his new firm in locations where his former customers will *see* the advertisements (and then initiate contact with him). The seller will not disparage the purchaser but will give "factual" information regarding his new venture and will inform his new colleagues about the former client so that they can effectively "pitch" the customer once the customer initiates contact.

In football, pundits claim that fans root for the "laundry," i.e., that they will remain fans of a particular team even if their favorite player is traded, cut, retires or leaves via free agency. Business is different. Customers often develop close relationships with a particular employee; they enjoy the familiarity and trust that employee's judgment. Customers have less "brand loyalty" and are simply looking for the person they trust to give them the right advice at the right price.

Therefore, it is important that the purchaser of an existing business take extra steps to ensure that the customers–the backbone of the business being acquired–do not walk out the door to join the seller who just received tons of money from the purchaser.

What the Purchaser Can Do to Protect Itself

In *Bessemer Trust*, the purchaser failed to obtain a key restrictive covenant: a non-compete. Simply stated, a non-compete prevents the seller from starting a new business (or joining another business) that competes with the purchaser. Under New York law, as long as the geographical scope is reasonable, the seller may be bound to a non-compete for as long as three to five years.[14] Thus, the non-compete effectively bars the seller from servicing any of the purchaser's customers until the restrictive period is over, by which time the purchaser should have gained the customer loyalty for himself.

Even in the absence of a non-compete (or if the non-compete is for a short period of time), the purchaser can still take protective steps. First, the purchaser should require the seller to help build customer loyalty after the sale. This can be done by employing the seller post-closing on a consultant basis and having him introduce the customers to other employees who will take over the accounts. This will require paying the seller more to consult, but can result in a process whereby the client loyalty is transferred to other individuals loyal to the purchaser, thus reducing the risk that customers will flee the minute the seller resigns.

Second, if the seller (one not subject to a non-compete) joins a competing company, the purchaser should promptly write to the seller and the competitor, setting forth the seller's ongoing contractual (express or implied) obligations. For example, where the seller has non-solicitation and confidentiality obligations, the letter should–without making threats–put the seller and competitor on notice that the purchaser will enforce these obligations. This may cause the seller and his new employer to avoid "pushing the envelope" by going after the former customers.

A business obtains revenue from its customers. The purchaser wants to maintain (and increase) these revenues. Given the New York Court of Appeals recent decision, a purchaser should not rely solely on an implied or express non-solicitation covenant but should take other proactive steps so that the purchaser –having paid good money for the business –does not *see* the customer/revenue base diluted.

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[1] *Mohawk Maintenance Co. v. Kessler*, 52 N.Y.2d 276, 283, 437 N.Y.S.2d 646 (1981).

[2] 16 N.Y.3d 549, 925 N.Y.S.2d 371, 2011 BL 111444 (April 28, 2011).

[3] *Id.* at 551-52.

[4] *Id.* at 552-53.

[5] *Id.* at 553-55.

[6] *Id.* at 557, quoting *Mohawk*, 52 N.Y.2d at 285.

[7] *Id.*

[8] *See, e.g.*, *Hyde Park Prods. Corp. v. Lerner Corp.*, 65 N.Y.2d 316, 321, 491 N.Y.S.2d 302 (1985); *USI Insurance Services LLC v. Miner*, No. 10-cv-08162 (S.D.N.Y. July 7, 2011).

[9] *Bessemer Trust*, 16 N.Y.3d at 558.

[10] *Id.*

[11] *Id.*

[12] *Id.* at 559. Other jurisdictions also recognize that there may not be a violation of a non-solicitation covenant where the customer initiates contact without inducement by the person subject to that covenant. *See Getman v. USI Holdings Corp.*, No. 05-3286-BLS2, 19 Mass. L.

[13] *Bessemer Trust* at 559-60.

[14] *See FTI Consulting, Inc. v. PriceWaterhouseCoopers, LLP*, 8 A.D.3d 145, 779 N.Y.S.2d 56, 57-58 (App. Div. 1st Dept. 2004); *Hadari v. Leshchinsky*, 242 A.D.2d 557, 662 N.Y.S.2d 85, 86 (App. Div. 2d Dept. 1997); *Brintec Corp. v. Akzo, N.V.*, 129 A.D.2d 447, 514 N.Y.S.2d 18, 19 (App. Div. 1st Dept. 1987).