The Increased Importance of Non-Compete Agreements for Accounting Firms

By Michael C. Lasky and David S. Greenberg

It has been said that it is wise to keep your friends close and your enemies closer. In these challenging economic times, accounting firms are increasingly following this maxim when it comes to postemployment restrictions for departing professionals. In fact, growing numbers of accounting firms are making certain that they have the right form of non-compete and protective covenant agreements in place with their employees, managers, and partners in order to ensure that accountants cannot leave the firm and take their books of business and client relations to a competitor. More and more well-known New York accounting firms are going to court to enforce their rights under such agreements when once-loyal accountants leave the firm and then seek to service former clients or hire employees from their former firm.

Many accounting firms recognize the importance of including the correct and updated form of a protective covenant in their employment agreements. Others, however, rely on covenants drafted many years ago, neglecting to revise agreements to reflect changes in an employee's seniority, market conditions, or the law. Even accounting firms that periodically update their protective covenants often implement them on a forward-looking basis only. Thus, these firms fail to require existing employees to agree to the updated provisions and are left without complete protection.

The discussion below explores some of the best practices for designing and updating protective covenants, as well as practical tips for implementing revised agreements with existing staff and for hiring accountants with preexisting contractual obligations. It will also focus on leading and recent court cases involving New York accounting firms.

Leading New York Court Case

The leading New York court case concerning the enforcement of postemployment protective covenants concerned a national accounting firm. The case—*BDO Seidman v. Hirschberg*, 93 N.Y.2d 382 (1999)—demonstrates why accounting firms should include carefully drafted protective covenants in their employment, partnership, and shareholder agreements.

In *BDO Seidman*, the defendant Hirschberg was an accountant whose local Buffalo firm had been acquired by BDO. When Hirschberg was promoted to manager at BDO, he signed an agreement that prohibited him from servicing BDO's clients for 18 months after the termination of his employment. In addition, it required that if Hirschberg violated the agreement, he would have to pay BDO 150% of a particular client's fees from the fiscal year prior to his departure from BDO. When Hirschberg resigned four years after his promotion, he then provided accounting services to several BDO clients—the equivalent of $138,000 in revenues to BDO in the year prior to his departure.

The New York Court of Appeals examined BDO's agreement with Hirschberg to determine whether it was enforceable. The law is clear that, regardless of the actual lan-

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guage in the covenant, only reasonable restrictions will be enforced. A "restraint is reasonable only if it: (1) is no greater than is required for the protection of the legitimate interest of the employer, (2) does not impose undue hardship on the employee, and (3) is not injurious to the public" (*BDO Seidman*, pp. 388–389).

The court emphasized that restrictions of this type are more likely to be enforceable against learned professionals who provide specialized services, such as accountants. It also scrutinized Hirschberg's covenant to determine whether BDO was indeed protecting a legitimate interest, and whether the covenant was tailored only as restrictively as necessary to protect that interest. The court ultimately held that the covenant was overly broad because it prohibited Hirschberg from servicing all BDO clients—even those Hirschberg himself recruited prior to joining BDO and those with whom Hirschberg had not developed any relationship as the result of his employment (*BDO Seidman*, p. 393).

Rather than simply discarding the overly broad covenant, however, the court next considered whether the covenant should have been enforced to the extent that it was reasonable. It found no evidence of BDO's deliberate overreaching, bad faith, or coercive abuse of superior bargaining power. Because of this, the court rewrote—that is, "blue-penciled"— the covenant to effectively narrow it by precluding Hirschberg only from servicing those clients with whom he had developed a relationship as a result of his employment with BDO (*BDO Seidman*, pp. 394–395). The court then sent the case back to the trial judge to determine whether BDO was entitled to receive damages based on the formula of 150% of the client's prior year's revenue, as specified in the covenant (*BDO Seidman*, p. 397). This case demonstrates how valuable protective covenants can be in guarding an accounting firm's business interests. But *BDO Seidman* also highlights the importance of choosing appropriate covenants for given employees and carefully drafting such covenants so that they contain reasonable and clearly defined terms.

Types of Protective Covenants

Protective covenants come in a variety of forms, and selecting the right covenant is the first step in protecting a business. The following sections examine five different types of covenants.

Noncompetition provision. The most restrictive covenant is the blanket noncompetition provision, which prevents employees from working in competition with their former firm for a specified period of time following the termination of employment. Because this type of covenant imposes the greatest restraints on an employee's ability to earn a living, courts are most reluctant to enforce it. A blanket noncompetition provision is appropriate for only the most senior members of an organization—if at all—and it is often utilized in the context of a larger firm's buyout of a smaller firm and the hiring of that smaller firm's principals as partners or senior executives. Blanket noncompetition provisions might also be appropriate for senior-level employees with wide-ranging access to sensitive confidential information, which would necessarily be disclosed if the employee were to go to work for a competitor.

Nonsolicit/nonservice provision. This provision is less restrictive than the blanket noncompetition provision; it prohibits former employees from soliciting or providing services to firm clients for a specified period of time. Because non-solicit provisions are narrower in scope than noncompetes, they are relatively easier to enforce when properly drafted. Non-solicit/nonservice provisions are appropriate for a broader range of employees than blanket noncompetition provisions, and firms commonly use them for both senior- and mid-level employees. These covenants can be appropriate even for junior employees who will have ongoing contact with firm clients. Moreover, such covenants can sometimes be expanded in scope for more senior employees who join the firm in the context of a buyout or merger, such that the covenants protect even those employees' preexisting clients brought to the firm—a category that is generally not protectable. (See *Weiser LLP v. Coopersmith*, 74 A.D.3d 465, 467 [1st Dep't 2010].)

Nonraid/nonhire provision. A nonraid/nonhire provision bars an employee from soliciting other firm employees for a period of time after departure. A nonraid provision can be useful when a given employee has few direct or exclusive relationships with firm clients, but works closely with other employees who do. Like nonsolicit/nonservice provisions, nonraid/nonhire provisions are commonly used for a wide range of employees at various levels of seniority.

Extended notice provision. This type of provision simply requires employees to give advanced notice of their resignation. The long lead time gives the firm a better chance to retain a client by introducing other personnel into the relationship, and it can assist the firm in retaining clients that the departing employee brought to the firm—a category of client that a nonsolicit/nonservice provision might not reach. Extended notice provisions can be appropriate for employees at all levels, regardless of whether those employees have contact with clients. The amount of notice required before resignation should be tailored to the employee's level of seniority, with longer periods appropriate for more senior employees.

Employment agreement. Last, employment agreements can contain an agreement that employees will not use the firm's confidential or proprietary information after departure. While the law itself prohibits departing employees from improperly using confidential information, a contractual provision can broaden the definition of confidential information and can eliminate disputes about whether specific types of information are protected from an employee's use. Such covenants are appropriate for employees at all levels.

Choosing and Drafting a Covenant

It often makes sense to use several of the provisions described above in combination in order to protect a company's interests. Firms should take a close look at the types of services being rendered by a given category of employees, the closeness of the employees' relationships with clients and other employees, and the nature of information to which the employees have regular access. Next, firms should select the appropriate blend of covenants to fit a situation; different types of employees might require different covenants, and firms might impose greater restrictions on partners or owners because of their contractual and fiduciary relationships with the firm and its other partners or owners.

Once a firm has chosen the appropriate covenants, it must refine them to make them more effective by not only defining

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the firm's protective covenants carefully and completely, but also by reasonably limiting their scope. The sections below describe the key strategies that accounting firms should use in working with legal counsel to draft protective covenants and avoid common pitfalls.

Leave nothing to guesswork. A protective covenant that fails to adequately define what it seeks to protect and prevent could fall short when put to the test—in other words: when in doubt, spell it out. By assuming that everyone knows what a given term means, firms run the risk that a court will end up defining that term for them—and the results might not work in favor of the firm seeking to enforce the covenant.

For example, the New York Court of Appeals recently decided a case defining what "solicitation" of a client means. In *Bessemer Trust Company v. Branin*, 16 N.Y.3d 549 (2011), an executive sold his wealth management company, began working for the buyer of his company, and then later resigned and joined a competitor. While the executive had not agreed to any specific protective covenants pursuant to the deal, New York law imposes certain nonsolicit obligations on the seller of a business because the purchaser is considered to be buying the seller's goodwill and ongoing client relationships.

Despite these obligations, the court held that the executive was still permitted 1) to answer a former client's questions about the competitor's business, 2) to assist the competitor in creating a pitch strategy for the former client, and 3) to even attend a meeting between the competitor and the former client (*Bessemer*, pp. 559–560). In the court's view, none of these constituted improper solicitation under the implied covenant inherent in the sale of a business.

Bessemer illustrates several important lessons. First, firms should not leave defining the terms in protective covenants or filling in missing provisions to the courts. An employment agreement should specifically define critical terms, such as what constitutes solicitation and who qualifies as a client subject to protection. Second, firms should examine their existing covenants to ensure they prohibit departing employees from not only soliciting clients, but also from servicing them. Otherwise, departing employees might find it easy to circumvent their protective covenants.

Defining the scope of protections: keep it reasonable. In addition to being clearly defined, a firm's protective covenants must be reasonable in scope. As *BDO Seidman* illustrated, courts will not enforce overly broad covenants. Thus, firms must be reasonable in defining their protected interests and their employees' prohibited conduct. Firms should not overreach; if a court sees overreaching, coercion, or bad faith by a firm, it will decline to partially enforce the agreement and will simply throw out the protective covenant in entirety. It is true that the New York Court of Appeals blue-penciled the protective covenant in *BDO Seidman* and that, more recently, another appellate court blue-penciled an overly broad covenant entered into between accounting firm Weiser LLP and its partners (*Weiser LLP*, p. 469).

Other New York courts, however, have refused to blue-pencil agreements between accounting firms and their employees; instead, they struck down the covenant in entirety. For example, in *Scott, Stackrow & Co., CPAs, P.C. v. Skavina*, 9 A.D.3d 805 (3d Dep't 2004), a New York appellate court refused to partially enforce an overly broad protective covenant that the accounting firm sought to impose on a staff accountant who joined the firm when it acquired her previous firm. The court noted that that the accounting firm had deliberately imposed the overly broad covenant on the accountant, prohibiting the defendant from servicing the firm's entire client base (regardless of whether she had any dealings with these clients), and had insisted that she sign the covenant each year despite offering her no promotion or increase in responsibilities (*Scott, Stackrow*, pp. 807–808).

Notably, the *Scott, Stackrow* decision illustrates the importance of routine "checkups" for a firm's protective covenants. The court specifically mentioned that the firm had continued to impose the overly broad covenant, even though the *BDO Seidman* decision had explained the reasonable limits of such covenants only a few years prior.

Good protective covenants impose clear but reasonable limits and conditions on what a departing employee can do. In the case of a blanket noncompetition covenant—which might be appropriate only for senior partners or key executives involved in firm-wide strategy who have access to specific types of highly confidential information—the agreement should define "competition." Where possible, the covenant should also specify those competitors for whom the employee may not work, and it should appropriately limit the period of time and the geographic area, if applicable, in which the employee may not compete. This type of covenant will more likely be enforced if the departing employee receives some continued compensation during the term of the noncompetition period.

A nonsolicit/nonservice provision should set forth a reasonable, definite time period of effect and should specifically define clients to include only actual or prospective firm customers that the firm last serviced within a specific, limited period prior to the employee's departure. The covenant should define clients to include only customers that the employee personally serviced or pitched.

As with the term competition, the terms "solicitation" and "service" should be clearly defined. Service should list the variety of services performed by the employee or offered by the firm (e.g., accounting, auditing, tax, management, consulting services). Similarly, solicitation should include direct or indirect efforts, such as assisting another person, to cause a firm client not only to engage the employee's new firm, but also to reduce, in any way, the amount of business the client does with the original firm. A nonraiding provision concerning the recruitment of other employees should likewise explicitly prohibit indirect efforts to recruit, such as assisting a new employer in doing so.

Put a price tag on a violation. Finally, when drafting clear and well-defined protective covenants, it can be advantageous for firms to set forth specific remedies in the event that departing employees violate their covenants. Because the damages arising from client loss can be difficult to quantify, accounting firms now commonly include liquidated damages provisions in their protective covenants. Such provisions require the exiting employee to pay a set sum (or a sum derived from a set formula) in the event of a violation of the agreement.

Courts will enforce a liquidated-damages clause if it does not result in the employee paying a sum that is considered grossly disproportionate to the harm anticipated at the time the parties signed the agreement. For example, in *BDO Seidman*,

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the court approved, in theory, a liquidated-damages formula based on 1.5 times the prior year's billings of the lost client, where the protective covenant lasted 18 months (*BDO Seidman*, p. 396). More recently, a New York court required a currency trader who competed with his former employer in violation of his covenant to pay an amount equal to the trader's average monthly commissions, multiplied by the number of months remaining in his covenant (*GFI Brokers LLC v. Santana*, 2008 WL 3166972 [S.D.N.Y 2008]). Likewise, a New York court approved a liquidated damages payment amounting to a consultant's contractual share of one year's estimated annual billings to a client lost to the consultant's subcontractor (*Crown It Services Inc. v. Koval-Olsen*, 11 A.D.3d 263 [1st Dep't 2004]). In all of these situations, the accounting firms designed the covenants to provide the revenue stream of the lost client, rather than trying to stop a once-trusted employee from servicing an unhappy client.

Another common and powerful remedy for breach of a protective covenant is an injunction—that is, a court order commanding the departed employee to stop working in violation of the covenant. The key to obtaining an injunction is a firm's demonstration that it will suffer irreparable harm if the employee continues violating the covenant. Courts generally recognize that the loss of client relationships and goodwill constitutes irreparable harm (e.g., *Ticor Title Ins. Co. v. Cohen*, 173 F.3d 63, 69 [2d Cir. 1999]). While the law itself provides for injunctive relief when the proper conditions have been met, protective covenants nonetheless often include an employee's explicit acknowledgement that a violation of the covenant would result in irreparable harm and that the firm, therefore, has the right to seek an injunction in the event of a breach; however, this acknowledgment would not necessarily prevent a court from finding that monetary damages would be sufficient to compensate the former employer for its loss, which could serve as an obstacle to securing the injunction.

There are at least two other difficulties with relying on injunctive relief. First, the accounting firm seeking to enforce the covenant has a very high burden of proof and needs to prove its case (typically on an emergency basis) before pretrial discovery. Meeting this high burden at such an early stage can be daunting. For example, in April 2011, a New York court refused to issue a preliminary injunction against J.H. Cohn LLP in a case involving several managing directors and partners who had departed RSM McGladrey, and who had allegedly violated covenants prohibiting their solicitation or servicing of McGladrey clients and their hiring of other McGladrey personnel (*RSM McGladrey Inc. v. J.H. Cohn LLP*, No. 650523-2011, slip op. at 14 [Sup. Ct. N.Y. County, April 8, 2011]). Despite the fact that McGladrey was able to secure injunctive relief against the managing directors and partners themselves in other state courts, the New York court found that McGladrey could not demonstrate a likelihood of success on the ultimate merits of its claims against J.H. Cohn and did not find that McGladrey would actually suffer irreparable harm in the absence of an injunction (*RSM McGladrey*, pp. 11–12).

Second, former employees are likely to argue that it was their former firm's failure to service a client's business properly that caused the client to terminate his business relationship with the firm—rather than the employee's violation of the covenant. In other words, a departing employee will typically decide that the best defense is to go on offense and put the conduct of his former accounting firm on trial. This is another reason why preset contractual remedies, such as liquidated damages, have become increasingly common in accounting firms' restrictive covenants.

Updating Covenants and Due Diligence in Hiring

Unlike some other jurisdictions, New York law recognizes that continued employment in an "at will" relationship is sufficient consideration to support new protective covenants. Thus, from a purely legal standpoint, an accounting firm does not need to offer employees any additional compensation in exchange for their agreement to sign new (and more stringent) protective covenants. As a practical matter, however, many accounting firms find that the best time to implement new covenants is in the third quarter, when many firms begin to consider salary increases for the following year and bonuses for the current year. The firm can present its new covenants to the employees and ask that the employees sign and return the new covenants by a date prior to the announcement of salary increases and bonuses.

In addition, accounting firms must consider any preexisting obligations that candidates have to their previous firms. Firms should always ask potential new hires if they are subject to protective covenants, confidentiality agreements, or any other agreements with their former firm; they should also insist on receiving and reviewing copies of such covenants during the interview process, ideally along with the firm's employment counsel. When possible, accounting firms should also make new accountants' employment contingent on their representation that they have provided the firm with all prior protective covenants, and that no prior agreements prevent them from working in the new position. This process ensures that an accounting firm's investment in a new accountant is protected not only against future loss of its client relationships, but also against claims by another firm seeking to protect its own such relationships.

The Bottom Line

Protective covenants offer accounting firms a powerful means of protecting their most valuable assets: their client relationships and their employees. It is critical for a firm to make sure its professionals agree to protective covenants that reduce the likelihood of losing clients or employees. With the right combination of protections—and provisions that clearly define those protections—savvy managing partners and executive committees of accounting firms can ensure that their firm's covenants will preserve the value of their business and include the latest industry trends and legal developments. These proactive measures can be the difference between the minimal disruption of losing one accountant and waving goodbye to a substantial book of business, revenues, and employees. ❑

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