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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@portfoliomedia.com

Restrictive Covenants Vs. Garden Leaves

Law360, New York (July 15, 2009) -- Imagine an employment contract in which an employer guarantees paid leave from work so long as the employee promises to give a certain amount of notice before resigning.

To some, that idea might seem like it is too good to be true. It certainly does not seem like the kind that would originate among employers looking for new ways to protect their business interests.

However, it is this very idea — employer enforced “garden leaves” — that has become a firmly entrenched practice in England and that is making its way to American workplaces.

Same Problem, Different Solutions

Employers invest a lot in employees. They entrust customers with them and give them the resources that they need to build relationships.

They give their employees confidential information and trade secrets, all with the intent that the employees will use them to gain an advantage over others in the market.

Finally, they often invest in training and educating their workforce to develop special skills that make their workers more knowledgeable and productive.

All of these investments can be at-risk when an employee resigns to accept work with a competitor, and employers have continually looked for ways to minimize the risks associated with a mobile work force.

There are two common solutions, one prevalent in the United States and the other gaining in popularity after being imported from overseas.

The most common practice in the United States to address these risks is to use restrictive covenants. Restrictive covenants are provisions in employment contracts that restrict what employees can do after they resign.

The most common covenants prohibit competition with the employer for a period of time after resignation (a noncompetition covenant) or forbid dealings with customers for some period (a nonsolicitation covenant).

These post-employment restrictions are intended to give the former employer a chance to transition relationships and responsibilities to a replacement without having to worry about competition from the departing employee in the interim.

The restraints are also intended to provide time for confidential information that had been shared with the departing employee to grow stale, a protection that can complement the restrictions of a nondisclosure agreement.

Thus, restrictive covenants are used by employers to protect important interests that are often implicated when an employee changes jobs.

A “garden leave” provision is also intended to protect an employer’s interests, but it approaches the problem from a different direction.

Rather than being a post-employment restriction, a garden leave clause is a restraint on when an employee can resign in the first place. In its purest form, a garden leave clause provides that an employee must give some amount of notice before resigning.

Usually, once the employee provides the notice, the employer then immediately relieves the employee of his responsibilities, but continues to pay him the compensation due until the garden leave period expires.

The employee is usually sent home on leave to await the expiration of the notice period, the ensuing termination of employment, and the eventual ability at that future time to take a new job.

Thus, just like restrictive covenants, garden leave provisions impose some period of time when an employee cannot work in a competing enterprise or do business with an employer’s customers for the benefit of someone else.

However, while garden leaves are intended to achieve the same goals as restrictive covenants, they rest on different legal principles.

Restraints on Trade v. Duties of Loyalty

There is at least one very important difference between restrictive covenants and garden leave agreements: the employment status of the departing employee when they are invoked.

As noted, restrictive covenants address the post-employment activities of the individual who signs them, and as such, they first become applicable after the employment relationship ends.

In contrast, garden leave provisions address when the employment relationship can end, and therefore, the individuals who sign them remain employed while the provisions are in effect.

From a legal perspective, the difference between the two approaches should have an important impact on the standards that govern their enforceability.

In the United States, restrictive covenants have been viewed by the courts as restraints on trade and impediments to an employee’s ability to earn a living.

Because restrictive covenants have some potentially anti-competitive and inequitable aspects to them, a whole body of case law has developed to determine whether and to what extent they will be enforced.

While the legal principles that apply can differ markedly from state to state, restrictive covenants tend to be enforced where they are supported by consideration; reasonable in duration, geographic reach and substantive scope; and no greater than necessary for the protection of the former employer’s legitimate interests.

The employer interests that are generally recognized as protectable include goodwill, investments in employee education or training, and the existence of confidential or trade secret information.

Typically, restrictive covenants will only be enforced to the extent that they are necessary to protect one of these interests, and the law of many states permits courts to modify restrictive covenants to narrow their scope.

As a result, inherent in the use of restrictive covenants is uncertainty about whether and to what extent they will be enforceable when invoked.

In contrast to restrictive covenants, garden leave provisions should rest on a different legal principles because of the individual's employment status.

At common law, employees owe their employers a duty of loyalty. This duty prohibits an employee from competing with the current employer, from disclosing confidential information or trade secrets that belong to the employer, and from diverting resources or opportunities meant for the employer to other parties.

At common law, an employee has these obligations simply virtue of her employment, and they continue to apply until the employment term ends.

Thus, because an individual remains employed during a garden leave period, the common law duty of loyalty should provide the legal basis that prohibits competition and the use or disclosure of confidential information.

Theoretically Different, But Judicial Review Pending

While garden leave provisions have been the subject of significant litigation in England, they have not generated much judicial review in the United States yet. Several reasons might account for the lack of case law.

One might be simply that garden leave agreements have not been widely used thus far, although they have grown in popularity in the financial industry.

However, in that industry, the garden leave provisions tend to be of limited duration, normally requiring only between 30 and 90 days' notice of resignation. The combination of lack of use and short durations might account for limited opportunities for litigated disputes to arise.

There is at least one reported decision involving a garden leave agreement in the financial industry.

Unfortunately, *Bear Stearns & Co. v. Sharon*[1] does not shed much light on whether the United States judicial system will judge the enforceability of garden leave provisions by applying straightforward common law duty of loyalty principles or by using the more nuanced analysis to which restrictive covenants are subjected.

In *Bear Stearns*, the departing employee resigned and immediately joined a competitor. The employee had signed a garden leave that required 90 days' notice of resignation, and *Bear Stearns* sought a preliminary injunction to enforce the notice period.

Without much analysis at all of the contract's enforceability, the district court refused injunctive relief, in part because it believed that *Bear Stearns* could not establish irreparable harm.[2]

Thus, it remains to be seen whether garden leave provisions will receive a warmer and less scrutinized reception in American courts than restrictive covenants have encountered.

From a theoretical perspective they should, although the way in which the agreements are drafted could have an impact on how American courts treat them.

The Impact of Drafting on Enforcement Standards

The purest form of a garden leave would be drafted in a manner in which the employee is required to give a defined period of notice before resigning, and in exchange, the employer is required to maintain the employee's full compensation during the leave period.

Like every drafted instrument, however, there can be variations on the theme. Employers can make choices about the length of notice required, the compensation to be paid during the leave period and even about the individual's employment status during the interim.

For example, a garden leave agreement that provides for 90 days' advance notice sounds very much like a notice provision.

However, if the required notice period were two years, something that is common for noncompetition covenants, a court might be persuaded to view the provision through a restrictive covenant prism and subject the clause to that analysis.

Likewise, the more that employers change compensation levels during the leave period, the more they might open themselves to the argument that the restraints imposed are more like post-employment restrictive covenants than they are like garden leave agreements.

This cross-over effect is particularly pronounced in some agreements which are more appropriately characterized as noncompetition agreements with pay.

Sometimes, clauses that are called "garden leaves" are drafted in a manner in which the employment relationship clearly terminates immediately, but the employer is willing to continue paying compensation during the period while noncompetition restraints remain in place.

The point is simply this: the more that employers draft the restraints in such a way that they resemble a restrictive covenant as opposed to a garden leave provision, the more arguable it becomes that the provision should be analyzed according to restrictive covenant standards.

The Pros and Cons of Garden Leave Agreements

The primary advantage of garden leave agreements should be the certainty of enforcement that follows from the absence of the multifaceted balancing tests that are used to evaluate restrictive covenants.

The common law duty of loyalty that workers owe their employers is well-recognized and imposes some bright lines: employees cannot work for two competing companies at the same time and cannot divert resources, opportunities and confidential information from one for the benefit of the other. Thus, a garden leave provision should be readily enforced when used in its purest form.

The primary disadvantage of garden leave agreements is the costs attendant to them. To get the benefit of the common law duty of loyalty, the employment relationship needs to be maintained.

That requires continued compensation, and the compensation is paid during a period when it is intended that the employee will not be working at all. Garden leave provisions thus have a definite and immediate financial impact upon the employer when they are invoked.

Conclusion

Restrictive covenants have a long history in the United States, but it is a litigious one. When disputed, restrictive covenants are subjected to intense scrutiny that involves a number of different legal principles, that is very fact sensitive, and that can result in judicial reformation of the covenants.

As a result, while restrictive covenants are an important tool that employers can use to protect their interests, they can be expensive to enforce and have uncertain results.

Garden leave agreements are an alternative. As the law surrounding them has developed in England, garden leave agreements rest on different legal principles that invoke brighter lines between permissible and impermissible conduct by the individuals who are subject to them.

Consequently, they can assist employers in protecting their legitimate interests with more certainty and less enforcement costs.

--By Paul J. Greco, Conrad O'Brien PC

Paul Greco is a partner with Conrad O'Brien in the firm's Philadelphia office.

The opinions expressed are those of the author and do not necessarily reflect the views of Portfolio Media, publisher of Law360.

[1] *Bear, Stearns & Co. Inc. v. Sharon*, 550 F. Supp.2d 174 (D. Mass. 2008).

[2] See *id.* at 178.