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Client Alert

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Employer Wins—New York Appellate Court Upholds Client Non-Solicitation and Liquidated Damages Claims under Accounting Firm Partnership Agreement

The Non-Compete and Trade Secrets Practice Group at Proskauer Rose LLP highlights for your attention the recent unanimous opinion (May 30, 2008) of the New York Appellate Division, First Department, in W*eiser LLP v. Jeffrey S. Coopersmith, et al.* The case involves restrictive covenant and liquidated damage claims by the plaintiff accounting firm against three former partners. The defendants had merged their accounting firm into the plaintiff (Weiser) and became partners, and then resigned almost six years later to compete against Weiser. The client non-solicitation, employee no-raid and liquidated damages provisions were found enforceable.[1]

We think this decision is important for the following reasons:

- **Sale of Business Test**: The Court reaffirmed that the more lenient "sale of business" test for assessing the reasonableness of restrictive covenants applies to all sellers of a business, including minority partners—e.g., partners in the seller who held minority interests that were exchanged for interests in the buyer and who continued as partners in the buyer. The Court also held that (based on *prima facie* evidence) the restrictive covenants in the Weiser partnership agreement (even as amended four years post-merger) were "ancillary" to the merger agreement, and qualified for review under the "sale of business" test.

- **Employment Agreement Test:** Albeit *in dictum*, the Court stated that the relevant partnership provisions (see below) would pass muster even under the more "exacting test" applicable to employment agreements (citing *BDO Seidman v. Hirshberg*, 93 N.Y.2d 382 (1999)). This provides some additional guidance on the enforceability of client and employee non-solicitation/"no service" provisions in employment agreements.

- **The Court Declined To Apply *BDO Seidman's* "Personal Client" Carve-Out:** Apparently some clients at issue were pre-existing and personal clients of the defendant sellers (i.e., clients with whom they had a relationship prior to joining Weiser). One of their defenses was that they were entitled to continue to do business with such pre-existing and personal clients pursuant to the 1999 holding of New York's highest court in *BDO Seidman*. That case held that the accounting firm employer had no "legitimate employer interest" in extending a restrictive covenant to "personal clients" of an employee who came to the firm solely to avail themselves of the employee's services and as a result of the employee's own "independent recruitment efforts." By characterizing the case as a "sale of business case,"

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1 Note that the case did not involve a "true" non-competition agreement broadly prohibiting the practice of accounting. Weiser acknowledged that the former partners were free to compete but would have to pay liquidated damages if they breached the client non-solicitation/"no service" provisions. In reversing the lower court and holding that Weiser had made a *prima facie* case, the Appellate Division reinstated the restrictive covenant and liquidated damages causes of action and set the stage for renewed proceedings in the Supreme Court below.

however, the Appellate Division rejected the application of this *BDO Seidman* carve-out.

- **Liquidated Damages:** The claimed liquidated damages in the case totaled approximately $3 million. The Court provided guidance on the standard for determining the reasonableness of a liquidated damage provision for the violation of a client non-solicitation provision: *prima facie* evidence showed that the amount stipulated as liquidated damages was "tied to what an arm's-length purchaser would have paid for a lost client account as a firm asset on a sale of Weiser's practice, and, as such, is a reasonable measure of the anticipated probable harm from a breach of the restrictive covenant." This standard requires some objective evidence establishing a relationship between damages from loss of a client account and probable harm—the liquidated damage provision cannot be speculative.

- **Illegal Pre-Departure Conduct:** The Court also found that certain pre-departure acts (e.g., using staff and equipment to set up their new firm and soliciting clients and employees to join them) gave rise to a *prima facie* breach of the defendants' fiduciary duties and the Weiser partnership agreement. This level of pre-departure activity is to be contrasted with the more limited level of pre-departure conduct that New York courts have held is permissible as "mere preparation" or as "merely informing" clients of an impending withdrawal or resignation.

We have attached a link on our Website to the Weiser decisions: click here to view the appellate opinion and click here to view the lower court opinion.

A further description of the case follows.

Factual Background

On July 30, 1999, Jeffrey Coopersmith, Michael Simon and William Vogel (the "Former Partners") entered into a merger agreement to combine their accounting firm, Lopez, Edwards, Frank & Co., LLP ("Lopez LLP"), with Weiser and become Weiser partners. In addition to the Merger Agreement, the Former Partners signed the 1998 Weiser Partnership Agreement ("WPA") which included, among other things, a restrictive covenant and a liquidated damages provision. That partnership agreement was superseded by a new partnership agreement in 2003.[2]

The final restrictive covenant provided that:

> A Former Partner shall not at any time during the period of twenty-four (24) months following the [Partner's withdrawal]: (i) directly or indirectly, either for himself or for any Person . . . solicit, take away or provide Services to any of the Partnership Clients, or (ii) become or remain associated with any Person . . . that solicits, takes away or provides Services to any of the Partnership's Clients, or (iii) directly or indirectly or by action in concert with others induces or solicits any individual who was an employee or Partner of the Partnership at any time during a six month period prior to the [Partner's withdrawal] . . . to withdraw from or terminate his employment with or membership in the Partnership. . . . It is acknowledged and agreed that the provision of Services to any Client by a Former Partner . . . shall be presumed to have followed a solicitation of such Client within the aforesaid twenty-four (24) month period in contravention of the terms of this Agreement.

The liquidated damages provision in the WPA was based on a complicated formula depending on whether the former partner generated billings from recurring work (e.g., audits) or special projects, and damages were based on a 12-month "look-back" test aggregating the value of time associated with servicing former clients (regardless of whether actually billed), as well as a percentage of previously distributed profits to the former partner.

In April 2005, the Former Partners gave notice of withdrawal from Weiser and stated their intent to continue to service the 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 merger—approximately 482 clients in total. The Former Partners expressed their view that the restrictive covenant and liquidated damages provisions of the WPA were overbroad, inapplicable, unenforceable, and contrary to New York law. Approximately three weeks later, Weiser filed suit. After Weiser presented its case, the defendants moved to dismiss. Justice Charles E. Ramos of the Commercial Division of the New York Supreme Court granted their motion to dismiss the causes of action in the complaint alleging breach of the restrictive covenant and fiduciary duty.

The Appellate Court's Reasoning

The Appellate Division reversed, holding that Weiser had established a *prima facie* case for enforcing the restrictive covenant and liquidated damage claims. The Appellate Division held that the restrictive covenant was ancillary to the 1999 sale of the business to Weiser, and it was enforceable because "it is not more extensive than reasonably necessary to protect Weiser's legitimate interest in enjoying the assets and

2 Apparently, the original restrictive covenant in the WPA at the time of the merger (1999) was amended in 2003 to correct a "loophole" regarding the determination of liquidated damages.

goodwill it had acquired pursuant to the merger agreement." The Appellate Division further noted that the Former Partners had agreed to be bound by the WPA and any amendments thereto in the merger agreement and elsewhere. The Appellate Division, *in dictum*, noted that it would have reached the same result even after reviewing Weiser's evidence under "the more exacting test applicable to employment contracts" (citing *BDO Seidman*).

The Appellate Division also found that Weiser had made out a *prima facie* case that the amount stipulated as liquidated damages was "tied to what an arm's-length purchaser would have paid for a lost client account as a firm asset on a sale of Weiser's practice, and, as such, is a reasonable measure of the anticipated probable harm from a breach of the restrictive covenant." Moreover, Weiser presented viable claims for breach of fiduciary duty based on the Former Partners pre-departure acts that "conflicted with Weiser's interests, including using its staff and equipment to set up their new firm and soliciting its [Weiser] clients and employees to follow them to their new firm." Such acts, the Appellate Division held, "amounted to more than merely informing Weiser's clients and employees of their impending withdrawal" and, thus, violated the WPA.

Next Step

Due to the procedural posture of the case, the reversal by the Appellate Division sends the case back to Justice Ramos for further proceedings. The Former Partners will be in a position to rebut the *prima facie* case, and we would assume that they will focus on whether the restrictive covenants were ancillary to the sale of the business, and, if not, whether *BDO Seidman* and the "personal client" carve out should apply, and whether the $3 million liquidated damages claim is reasonable. Whether the case will wind its way up to the Court of Appeals remains to be seen.

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If you have any questions about the impact of this new decision, please contact your Proskauer relationship attorney or one of the attorneys listed below:

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