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Setting up a competing business

Inside

Introduction

Many owner-managers and entrepreneurs plan to start new businesses in the same space as their current one. Managing this transition effectively is often the key to success in the new business and getting it wrong can result in the new business failing before it has even started.

In this extensively litigated area, it is vital to have an effective strategy in place to manage potential risks while exploring the competing business opportunity.

This Inbrief is aimed at entrepreneurs and owner-managers who are seeking to start a competing business. It introduces the basic legal concepts and explains the practical issues that arise when doing so.

Contractual duties

The duties you owe to the existing business will depend on your status, which may be one or more of director, employee, partner, limited liability partnership (LLP) member or shareholder.

The express contractual terms between you and the business will be the first place to look for the key obligations that will apply both during your relationship with the business and after it ends. These terms can be found in a variety of places, including service agreements, shareholders' agreements, membership or partnership agreements and long-tern incentive plans (LTIPs) or other remuneration schemes. If several different agreements are in place, you will need to check carefully to see which set of provisions takes precedence over the others.

In addition to express terms, various implied terms may also be relevant. For example, all employees owe an implied duty of fidelity to their employer, which means they must have regard to their employer's interests and serve the business loyally. Statutory directors, LLP members and partners also owe fiduciary duties, requiring them to act in the best interests of the business at all times, even at the expense of their own interests.

Recently, we have seen a trend of businesses adding implied protections as express terms into their contracts. The courts have shown an increased willingness to enforce terms that are onerous for individuals to comply with and have been prepared to grant businesses relief when individuals have breached such requirements.

Specific obligations of this type to be alive to include:

- to act in the business's best interests at all times
- to report your own and others' actual or prospective wrongdoing
- to disclose any information which may adversely affect the business's interest (e.g. the launch of a competing business).

Overall, the effect of these duties will be to limit the steps you can take to set up your competing business while you owe obligations to the existing business (discussed further below).

Confidential information

As part of your relationship with the existing business, you are likely to have access to some of its confidential information. The law only provides very basic implied protections for confidential information - for example, employees cannot misuse "trade secrets" after termination of their employment. Trade secrets are typically limited to things like confidential algorithms, designs, formulae and (possibly) highly secret business strategies. As a result, rather than relying on weak implied protections, many businesses include express contractual terms – or even standalone confidentiality agreements – designed to ensure that confidential information is protected during the relationship with the individual and after it has ended.

Confidentiality clauses often include definitions of what the business considers to constitute "confidential information". Typically, such a definition will include lists and details of clients and prospects, terms of business, pricing strategies, marketing plans, forecasts and pitches, together with any other specific, sensitive information to which the individual in question has access.

You will need to consider carefully any information you may wish to use as part of setting up or running the competing business. Special caution should be exercised where:

- commercially sensitive information is labelled as "confidential"
- documents are password protected
- access is subject to security measures
- you are required to return business property, including hard and soft copies of documents, memory sticks and devices, and are required to permanently delete documents on personal devices or email.

You should also be aware of the business's intellectual property (IP) rights. Using any inventions, works, designs, databases or names without authorisation to set up the competing business may infringe those rights.

Finally, data protection legislation can also be relevant. Under the Data Protection Act 2018, it is a criminal offence to knowingly or recklessly obtain or disclose personal data without the consent of the data controller. A similar provision existed under earlier legislation and led to the conviction of an employee for unlawfully taking the personal data of customers when moving to a competitor. Businesses invariably treat breaches of this nature very seriously as they may have duties to protect the information from misuse and to report to the regulator, depending on the circumstances.

Notice periods and garden leave

Businesses will often have well-drafted, clear provisions in their contracts giving them control

over the departure of individuals from the business, including applicable notice periods.

In many situations in which an individual is serving notice, the business may want them to stay away from work for all (or part) of their notice period. This enforced period away from work is often referred to as "garden leave".

Garden leave can be used by a business to minimise or mitigate the potential damage that could be caused. For instance, a new executive could be brought in to manage and/or develop a client relationship while the departing individual is kept "out of the market". As garden leave is generally easier to enforce than restrictive covenants (see below), it can provide a business with an alternative means of ensuring effective protect against competitive threats.

During any period of garden leave, your contractual obligations will continue to apply in full. While it may be tempting to use this time to develop plans for the competing business, the same limitations on your activities continue to apply and the business may be monitoring your activities to ensure you do not breach your obligations.

There is no automatic right to place an individual on garden leave. Requiring someone to remain away from work during a period of notice in the absence of an express clause may lead to them arguing that there has been a breach of contract by the business, with the consequence that they are discharged from ongoing obligations. There are pros and cons for individuals in running this type of argument. We recommend seeking specialist legal advice on your specific circumstances before raising it.

Preparatory steps

An intention to set up a competing business does not on its own trigger a breach of legal obligations. Non-fiduciaries generally have more freedom than fiduciaries, who must act in the best interests of the business even if this is detrimental to their own personal interests (see above). All departing individuals can take some preparatory steps to set up a competing business, so long as this does not tip over into actual competition.

The line between what is an acceptable preparatory step and what breaches a departing individual's obligations is a fiercely litigated area. Examples of steps which may be acceptable (subject to any express obligations to the contrary) include:

- purchasing an off-the-shelf company
- arranging to lease business premises
- meeting potential investors
- taking legal and accountancy advice
- preparing a business plan.

Preparatory steps should not be carried out during normal working time or using the business's resources, systems or contacts.

Restrictive covenants

Restrictive covenants, also known as "post-termination restraints" (PTRs), are designed to protect businesses against competitive activities by former directors, employees, partners, LLP members or shareholders. These provisions apply for a fixed period of time immediately after your relationship with the business ends.

PTRs typically include the following:

- A **non-compete** restriction prevents you from engaging in competitive activities at all, which for practical purposes means not starting the competing business during the term of the covenant
- A **non-solicitation** restriction stops you from seeking business from specified clients or prospective clients of the existing business
- A **non-dealing** restriction prohibits you from having any dealings with clients or prospective clients
- A **non-poaching** restriction prevents you from employing, engaging or enticing others away to join the competing business
- A **non-interference** restriction prevents you from seeking to divert supplier relationships away from the business, typically for the benefit of the competing business.

The duration of the non-compete, non-solicitation, non-dealing and non-interference restrictions will typically depend on your status: for employees this will be shorter, for partners and shareholders longer. Duration will also depend on the circumstances of the business and what may be considered reasonable for your particular role.

Any restrictions on activities that go further than reasonably necessary to protect a "legitimate business interest" will be void for being in restraint of trade and unenforceable. Legitimate business interests can include protecting confidential information and trade secrets, client contacts, goodwill, relationships with suppliers and maintaining a stable workforce.

What is "reasonable" will depend on the particular business and the departing individual's status. Courts usually adopt a more critical approach to restrictive covenants in employment contracts than partnership or shareholder agreements, because of the actual or perceived inequality of bargaining power between an employer and employee. The burden is on the business to prove that the restriction is reasonable and goes no further than necessary.

Importantly, the courts judge the reasonableness of the restriction at the point at which it was agreed and not when the relationship ends. This means that you should check the last version of the relevant contractual documents. Restrictions can also be affirmed - some businesses do this on a regular basis by linking the affirmation with awarding bonuses or promotions.

Team moves

.When two or more departing individuals leave a business at the same this is often referred to as a "team move". If this is organised while the individuals are still working for the existing business, it is likely to involve breaches of both express and implied obligations.

Some businesses have express anti-team move PTRs in their contracts designed to prevent more than one departing individual from working together in a competing business. This type of restriction has not yet been properly tested in the courts, so there is a debate over whether such clauses go beyond the necessary protection of legitimate business interests.

Enforcement

If you breach your duties or restrictive covenants, or threaten to do so, the existing business can seek relief from the courts.

Typically, it can take many months to reach a full hearing in litigation. It is, however, possible for a business to apply to the High Court for an order restraining a departing individual from acting in breach of their obligations until trial or

limiting the impact of damage already caused (an "interim injunction"). This can be obtained on an urgent basis, within a matter of days. The court will normally be asked to:

- enforce express restrictive covenants and other ongoing obligations in the contract; and/or
- to order "springboard" relief - a discretionary remedy intended to cancel out the unfair advantage which a departing individual (or competing business) may have gained as a result of the individual's breach of legal obligations.

The courts have broad powers to grant a variety of orders, from restraining a departing individual from working for the competing business to forcing a return of confidential information.

The competing business, as well as any financial backers, may also be liable for any the following "torts" (civil wrongs):

- knowing inducement of a breach of contract
- causing loss by unlawful means
- conspiracy
- dishonest assistance in breach of fiduciary duty
- misuse of confidential information

The impact of orders granted by the courts, added to the cost of defending such claims, can result in the complete closure of the competing business. Having a strategy in place from the outset is vital to minimise any potential liability for you, your competing business and its financial backers.

Challenging restrictive covenants

In situations where the enforceability of restrictions is in doubt, you may decide to take steps at an early stage to "flush out" whether there is likely to be a dispute in the future.

One option to consider is to put the business on early notice that you consider the restrictions to be unenforceable and intend to breach them, inviting the business to seek an injunction at an early stage, and before any applicable notice period ends, if the business disagrees.

Another option available is to seek a declaration from the courts on enforceability, rather than wait to see if the business will try to enforce the restrictions. This type of "pre-emptive strike" is expensive but can be effective to release you from obligations which would otherwise severely restrict your ability to get a competing business up and running.

In many cases, the first you will know about potential enforcement is receiving a letter before action from the business. This will typically ask for satisfactory undertakings to be given, usually within a matter of days, failing which the business will issue court proceedings.

If an injunction application is threatened, you should consider the following practical steps:

- set up a strategy for legal advice and privilege. If the financial backers or others involved in the competing business will need to be updated, consider a common interest privilege agreement.
- give serious consideration to what undertakings could be given, even on an interim basis, to avoid immediate legal action.
- keep focused on the competing business's commercial objectives. Litigation is both expensive and disruptive, and the optimum solution is often to negotiate a compromise.

How we can help further

- Lewis Silkin can help to develop a strategy right at the outset of your planning, to reduce risks of potential breaches and potential liability.
- We can review relevant agreements, duties and restrictive covenants and advise on their enforceability.
- Before starting any preparatory work to set up the competing business, we can advise on key areas of risk and practical steps you can take to manage those risks.
- We can advise on how to approach and plan your departure in a way that fits in with the timetable for the competing business.
- When litigation is threatened, we can provide full support including strategies to mitigate your risks as well as defending or bringing action in the courts where necessary.

For further information on this subject please contact:

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