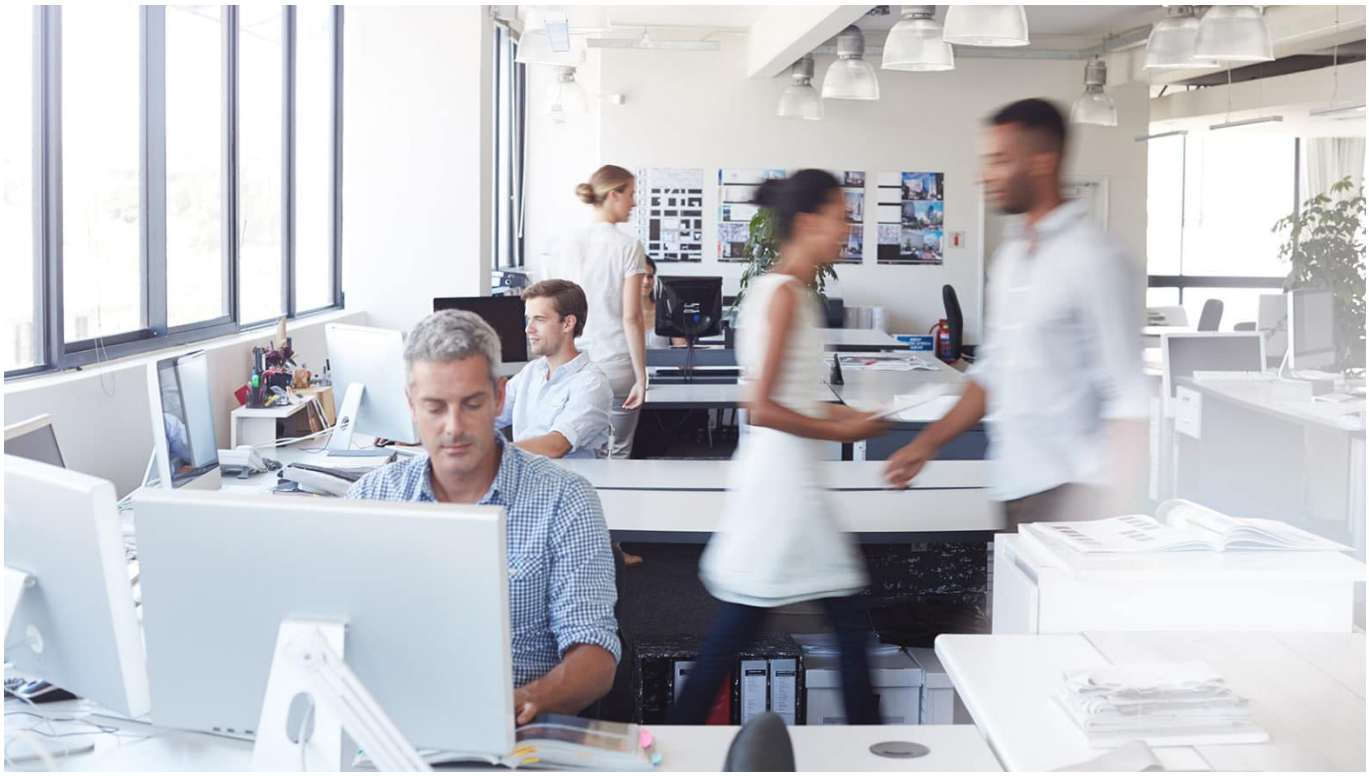
Cripps

Employee shareholders – beware of restrictive covenants attached to the shares



Getting equity (shares) in the company that you work for can be a valuable reward. However employees should pay close attention to the terms that may be attached.

During the course of their employment people learn business secrets and information that would be useful if they moved to a competitor. For this reason it is common for employment contracts to contain what are known as restrictive covenants. These set out restrictions on what an employee can do when they leave. For example, an employee may be prevented for working for a competitor for a period of time following their departure.

Such covenants are a restraint on trade because they affect people's ability to earn their living. For this reason they are examined carefully by the courts and will only be enforced if they are reasonably required to protect legitimate business interests.

Similar covenants are often added to shareholders agreements which are put in place when employees are granted shares or share options in a company. The covenants may impose restrictions whilst a person is a shareholder and for a period afterwards.

These covenants have traditionally been looked at differently by the courts. The relationship between shareholders has been viewed in a different light to that between employer / employee and therefore the courts have been more ready to enforce covenants that are harsher in terms of the restrictions and duration than would be enforced if they were in an employment contract.

For this reason employees given shares should pay close attention to the terms of any covenants in a

shareholders agreement and should not assume that the same principles will be applied as if they were covenants in an employment contract.

The degree of risk will depend upon the facts. At one end of the spectrum are covenants negotiated between major shareholders of a company, or on the sale of major shareholdings, which are more likely to be found to be enforceable. At the other end are covenants attached to small shareholdings given to employees as part of a share participation scheme. At this end of the spectrum it is more likely that the courts will approach the covenants on effectively the same basis as those in the employer / employee relationship.

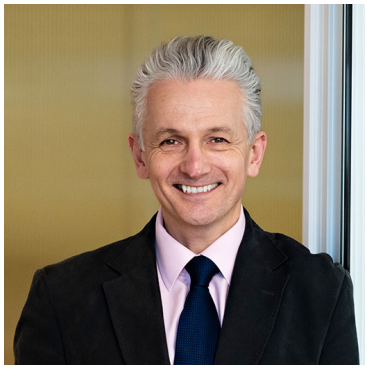
However, a Court of Appeal case (Guest Services Worldwide Limited v David Shelmerdine [2020] EWCA Civ 85) has highlighted the risks in this respect.

The claimant was an employee shareholder and covenants in the shareholder agreement prevented him from acting for a competitor whilst he was a shareholder and for 12 months after he ceased to be a shareholder. There were compulsory transfer provisions in the shareholders agreement which provided a mechanism for purchase of his shares, but this mechanism could take some time and there was no guarantee that it would conclude with a transfer of shares.

Thus it appeared that he could potentially be prevented from earning his living with a competitor for a period considerably in excess of 12 months or even indefinitely. The leading Judge held that "I do not consider that the clause should be declared to be unreasonable on the basis of the relatively unlikely possibility that there may be considerable delay or the extreme and very unlikely possibility that a shareholder may be locked in indefinitely."

This is a harsh result, particularly given that in practice the prospect of a shareholder being locked in for a long time or even indefinitely is not that unlikely as most compulsory transfer provisions are not compulsory from the point of view of the other shareholders being obliged to purchase the shares. An unscrupulous employer / majority shareholder appears to be given free rein by this judgment to spin out the process to extend the duration of covenants. Employee shareholders beware!

Written by



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