SUTHERLAND

LEGAL ALERT

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How Georgia's New Restrictive Covenants Laws May Impact Broker-Dealers

On November 2, 2010, Georgia voters approved an amendment to the Constitution of Georgia ratifying new legislation that dramatically changes the state's law on restrictive covenants. This new law may affect the ability of registered representatives to solicit clients when the representative departs one firm to join another firm, depending on whether the firms are signatories to the Protocol for Broker Recruiting (the "Protocol"). If a registered representative moves from one signatory firm to another signatory firm, the new Georgia law will have little or no effect on the restrictions and parameters set forth in the Protocol. If, however, a registered representative moves between non-signatory firms, or between one firm that is a signatory and another that is not a signatory, the new Georgia law could have a profound effect on the interpretation of any contract containing a restrictive covenant. Regardless of whether the firm is a signatory to the Protocol, firms and registered representatives must comply with privacy notices to customers, which may or may not allow sharing of information when a representative departs.

Georgia courts have traditionally applied strict scrutiny to restrictive covenants subject to Georgia law. Restrictive covenants have been voided based on minor technicalities or novel interpretations of the prior law. The new law was drafted with the stated intention of providing guidance to parties entering into such agreements on or after November 3, 2010.[1] Most notably, the legislature has reduced the level of scrutiny generally applied to restrictive covenants, authorized courts to "blue-pencil" overly broad covenants, and provided several presumptions to guide courts in their analysis of what time, territory, and activity restrictions are reasonable. As a result, broker-dealers will be more likely to be able to enforce restrictive covenants.

Restrictive Covenants Prior to Departure

Restrictive covenants that prohibit a registered representative from soliciting clients prior to his or her departure will be more likely to be upheld under the new Georgia law. The law creates several presumptions that apply to limiting competition *during* the course of an employment or business relationship.[2] First, the law requires the court to presume that a time period equal to or measured by the term of the parties' business or commercial relationship is reasonable.[3] Second, the law treats a geographic limitation defined by the areas in which the firm does business at any time during the relationship, even if not known at the time the agreement is signed, as reasonable if certain conditions are satisfied.[4] Third, the law measures the scope of prohibited activities by the business of the firm, and the firm may enforce partial violations of the restrictive covenant.[5] Finally, any restriction that operates during the term of an employment, independent contractor, or other ongoing business relationship will not be considered unreasonable due to the lack of specific time, territory, or activity restrictions, "so long as it

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1 O.C.G.A. § 13-8-50.

2 O.C.G.A. § 13-8-56.

3 O.C.G.A. § 13-8-56(1).

4 O.C.G.A. § 13-8-56(2).

5 O.C.G.A. § 13-8-56(3).

promotes or protects the purpose or subject matter of the agreement or relationship or deters any potential conflict of interest."[6]

Restrictive Covenants After Departure

Many restrictive covenants that prohibit a registered representative from soliciting clients after his or her departure are also more likely to be upheld under the new Georgia law. The new law allows courts to enforce post-termination non-compete clauses against persons who fall in at least one of the following categories:

- They solicit customers or prospective customers;
- They regularly make sales, obtain orders or obtain contracts for products or services;
- They manage two or more employees and have the authority to hire or fire other employees;
- They have gained high notoriety or prominence with the employer's customers; or
- They are highly educated professionals.[7]

Most, if not all, registered representatives will fall within at least two of the foregoing categories. If a departing representative falls within one of these categories, firms will have substantial flexibility in describing the applicable territorial and scope of activity restrictions. The new Georgia law provides that whenever a description of:

> activities, products, and services, or geographic areas, is required by this Code section, any description that provides fair notice of the maximum reasonable scope of the restraint shall satisfy such requirement, even if the description is generalized or could possibly be stated more narrowly to exclude extraneous matters.[8]

Solicitation of Clients After Departure

The law permits post-termination restrictions prohibiting the employee from "soliciting, or attempting to solicit, directly or by assisting others, any business from any of such employer's customers, including actively seeking prospective customers with whom the employee had *material contact* during his or her employment for the purpose of providing products or services that are competitive with those provided by the employer's business"[9] (emphasis supplied). No geographical restrictions are required in restrictive covenants containing customer non-solicitation clauses. The term "material contact," as used in the new non-solicitation provision, could expand the classes of customers that the departing representative cannot solicit. Under the new law, an employer may prohibit solicitation of actual or prospective customers:

- With whom or which the employee dealt on behalf of the employer;
- Whose dealings with the employer were coordinated or supervised by the employee;
- About whom the employee obtained confidential information in the ordinary course of business; or

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6 O.C.G.A. § 13-8-56(4).

7 O.C.G.A. § 13-8-53(a)

8 O.C.G.A. § 13-8-53(c)(1)

9 O.C.G.A. § 13-8-53(b).

- Who receive products and services authorized by the employer, the sale or provision of which resulted in commissions, compensation or earnings for the employee within the two-year period prior to the date of termination.[10]

The law states that a post-termination restraint, including non-solicitation clauses, longer than two years is unreasonable and a restraint less than two years is reasonable. Firms should be aware, however, that if they try to enforce a post-employment restriction against a former registered representative, the court still may consider whether enforcement would be an economic hardship to the representative.[11]

Non-Disclosure Clauses

Under prior Georgia common law, non-disclosure and confidentiality restrictions were required to have an express time limitation to be enforceable. The new law appears to eliminate the requirement of an express time limitation, but does not eliminate the possibility that the court would conclude that confidential information is no longer subject to protection.[12] Thus, it appears that non-disclosure covenants will not be rendered void as a matter of law for lack of an express time restriction. Notwithstanding this change, however, the new law does not alter the burden on the party claiming the protection of such a covenant to demonstrate that the information truly is confidential.

The Protocol for Broker Recruiting

The new law should not adversely affect the enforceability of the Protocol when a registered representative departs a firm that is a signatory to the Protocol to join a firm that is also a signatory. The Protocol establishes rules governing the movement of registered representatives between firms that are both signatories to the Protocol. When both the prior firm and the hiring firm are signatories to the Protocol, the Protocol allows a registered representative to take the following account information to the new firm: client name, address, phone number, email address, and account title of the clients that he or she serviced while at the firm. The Protocol prohibits the representative from taking any other documents or information. The Protocol further provides that the new firm will limit use of the information to solicitation by the representative of his or her former clients and will not permit the information to be used by any other representative or for any other purpose.

If a representative departs a firm that is not a signatory to the Protocol, and the representative is bound by a restrictive covenant that he or she signed with the departing firm, the new law will govern the agreement if the parties executed the agreement or amended a prior agreement on or after November 3, 2010, if it is determined that Georgia law applies to the agreement. Therefore, firms seeking to take advantage of the new Georgia law may find it advisable to draft new agreements for new representatives or amend their current agreements with existing representatives.

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[10] O.C.G.A. § 13-8-51(10).

[11] O.C.G.A. § 13-8-58(d).

[12] O.C.G.A. § 13-8-53(e). This provision appears to bring the law governing confidentiality agreements in line with the Georgia Trade Secrets Act, which provides that "a contractual duty to maintain a trade secret or limit use of a trade secret shall not be deemed void or unenforceable solely for lack of a durational or geographic limitation on the duty." O.C.G.A. § 10-1-767(b)(1).

Enforcement of November 3, 2010 and Later Agreements

The law authorizes, but does not require, a court to modify an otherwise overly broad restrictive covenant to sever the offending provision and enforce the remaining provisions to the extent they are reasonable.[13] Although it is unclear how courts will apply this provision, the law appears to permit modification only if the offending language may be struck from the agreement without rendering the covenant meaningless (*i.e.*, "blue-penciling"). The new law does not, however, indicate that the court is permitted to substitute new language for the parties. For example, if a geographic restriction prohibits the representative from soliciting persons who live in "the Southeast," and that provision is held to be overly broad, the court cannot effectively sever the offending language without rendering the restriction meaningless. By contrast, if the covenant lists all of the states intended to comprise the restricted territory, the court can remove the offending provisions and enforce the remainder of the covenant. This change also appears to eliminate Georgia's long-standing rule that non-solicitation and non-competition provisions may not be severed from each other.

Impact of Federal Law

The new law does not affect federal laws that govern the relationships among registered representatives, customers and firms.[14] For example, the new law does not change a firm's obligation pursuant to Federal Regulation S-P ("Reg S-P") to maintain the privacy of customer information. In May 2008, the United States Securities and Exchange Commission proposed changes to Reg S-P that would allow one firm to disclose certain customer information to another, in part to address the movement of representatives between firms. The proposed changes, however, have not been adopted. Firms should continue to ensure that their privacy notices to customers clearly explain the circumstances under which firms disclose customer information.

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If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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[13] *See* O.C.G.A. §§ 13-8-51(11, 12); 13-8-53(d); 13-8-54(b).

[14] O.C.G.A. § 13-8-59.

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