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How long is too long? Construing non-compete restrictions in shareholders' agreements

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Non-compete restrictions for key stakeholders are common in shareholders' agreements. In *Guest Services Worldwide v Shelmerdine*,[1] the Court of Appeal upheld a 12-month post-departure restriction, rejecting arguments that outgoing personnel risked being locked in indefinitely if unable to sell their shares.

Facts

The dispute arose from a shareholders' agreement for a business producing maps for luxury hotels. Mr Shelmerdine founded the business, and Guest Services subsequently acquired it. Post-acquisition, Mr Shelmerdine continued to provide his expertise as an employee, and later as a consultant.

Mr Shelmerdine was also a shareholder of Guest Services. The shareholders' agreement imposed non-compete obligations on "Employee Shareholders" (including consultants) while they were shareholders, and for 12 months thereafter.[2]

Guest Services alleged that Mr Shelmerdine had breached the non-compete provisions by soliciting business from various hotels after his consultancy arrangement terminated in February 2019.

In response, Mr Shelmerdine argued that, although he was still a shareholder after his consultancy terminated, he was not an "Employee Shareholder". On his case, he was no longer subject to the non-compete clause. He submitted that the parties to the shareholders' agreement could not have intended outgoing personnel to be bound by non-compete provisions while they waited to dispose of their shares under

1 Guest Services Worldwide Limited -v- David Shelmerdine [2020] EWCA Civ 85.

2 "Employee Shareholders" included "*any Shareholder who is also an employee, agent or director of the Company and those Shareholders who are Employee Shareholders as at the date of the Agreement are identified as such in the table at Schedule 1*". The non-compete obligations were in the form of restrictive covenants preventing Employee Shareholders from competing with the company's business, dealing with its customers or soliciting its customers, employers or suppliers.

compulsory share transfer provisions in Guest Services' articles of association.[3] At worst, such shareholders could be locked into the non-compete clause indefinitely if they could not find a suitable buyer for their shares.

Issues

Two key issues arose:

- Did Mr Shelmerdine stop being an "Employee Shareholder" when his consultancy terminated in February 2019? If so, the non-compete clause would no longer apply to him, even though he remained a shareholder. If not, Mr Shelmerdine would be bound by the restriction for as long as he remained a shareholder, and for 12 months thereafter.

- If the non-compete clause applied, was the restriction's 12-month duration longer than necessary to protect Guest Services' legitimate business interests? If so, the clause would be unenforceable as a matter of public policy.

Decision

Overturning the High Court's decision, the Court of Appeal found that the non-compete restriction was binding on Mr Shelmerdine even after his consultancy ended. It also concluded that the restriction's 12-month duration was reasonable.

Mr Shelmerdine was still an "Employee Shareholder"

The Court considered the objective meaning of "Employee Shareholder" in the context of the factual and commercial context at the time of the shareholders' agreement, finding:

- The shareholders' agreement distinguished between "Employee Shareholders" and investor-shareholders with no day-to-day knowledge or involvement in the business. The purpose of imposing non-compete obligations on Employee Shareholders was to protect the business, its goodwill and share value. It would make "*no commercial sense at all if the restrictions in [the shareholders' agreement could] be avoided altogether and with immediate effect, by terminating one's employment, agency or directorship*".[4] That would, in most situations, render the 12-month restriction meaningless.

- Guest Services' articles of association were also important. Their compulsory share transfer provisions expressly included anyone who "*is or has been*" an employee (or consultant). A reasonable person at the time of the shareholders' agreement would have envisaged that an outgoing employee-shareholder would transfer their shares around the same time as they left as an employee. The delay that Mr Shelmerdine faced in disposing of his shares in this particular case did not change this. Nor did the hypothetical, but very unlikely, prospect of a shareholder being unable to transfer their shares indefinitely.

- Non-compete provisions in an employment contract or agency agreement did not justify depriving the non-compete obligations in the shareholders' agreement of any real force.

The Court held that Mr Shelmerdine was still an Employee Shareholder, despite the termination of his consultancy. Accordingly, he remained subject to the non-compete obligations in the shareholders' agreement.

The 12-month duration was reasonable

The Court held that the non-compete clause's 12-month duration was reasonable in the circumstances. It is settled law that all restraint of trade covenants need to be reasonable to be enforceable, although courts are "*less vigilant*" when considering the duration of non-compete clauses in a shareholders' agreement, as

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3 Guest Services' articles of association contained compulsory share transfer provisions for outgoing employee shareholders. This included a valuation procedure for "*good leavers*" and "*bad leavers*", shareholder pre-emption rights, and (absent pre-emption) a right to sell the shares to third parties.

4 At paragraph 33.

compared with those in employment contracts.[5] Context is all-important.A non-compete clause agreed between commercially sophisticated partners, for example, may be very different to an employee acquiring a small shareholding in a share participation scheme.

Here, the Court considered various factors in upholding the non-compete clause:

- The shareholders' agreement was between experienced commercial parties.
- The prospect of a significant delay between departing as an employee/consultant, and ceasing to be a shareholder, was relatively unlikely. Being "*locked in indefinitely*" was an "*extreme and very unlikely possibility*".[6]
- In the circumstances, Guest Services had a legitimate interest in seeking to enforce the non-compete restrictions to prevent Employee Shareholders from using their close knowledge of its business to compete and solicit clients for a 12-month period.

Comment

This relatively rare decision on non-compete restrictions in shareholders' agreements will be welcome news for companies and investors looking to manage the risks of departing shareholders. Key personnel can be critical to day-to-day operations and long-term expansion. The effect of them leaving the business can be hugely disruptive. Where departing personnel set up rival businesses, this can dramatically erode goodwill and value. This decision shows that the Court is unlikely to be sympathetic to breaches of non-compete clauses in shareholders' agreements between experienced commercial parties, and emphasises that careful drafting of such clauses is crucial.

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5 At paragraph 41.

6 At paragraph 43.