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What private equity sponsors need to know about an implied permanent nonsolicitation covenant under New York law

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Noncompetition and nonsolicitation restrictive covenants are familiar tools often used in mergers and acquisitions to encourage retention of key employees of a sold business and to discourage the seller or key employees from poaching important customers or suppliers post-sale.

Private equity sponsors sometimes resist such restrictive covenants when selling a portfolio company to avoid limiting future investment opportunities.

When a sale agreement is governed by New York law, it might come as a surprise to a private equity seller to learn of an important common law restriction on customer solicitation known as the *Mohawk* doctrine.

Named after the New York Court of Appeals' decision in *Mohawk Maintenance Co. v. Kessler*,[1] the *Mohawk* doctrine imposes a permanent covenant on the seller of a business not to solicit the seller's former customers when the sale of the business includes its "good will."

Because many private equity sponsors buy and sell portfolio companies within the same industry or sector, this doctrine may have significant implications for sponsors.

THE *MOHAWK* DECISION

In *Mohawk*, the seller sold the buyer his controlling interest in a maintenance services company. Following the sale, the seller continued working for the business for six years.

He then resigned and formed a competing maintenance services company. Upon forming the competitive business, he began soliciting his former customers to lure them away from the sold business.

The buyer brought suit in New York state court seeking, inter alia, a permanent injunction that would prevent the seller and his new competing business from soliciting the sold business's customers.

The New York Court of Appeals affirmed the decision of the lower court, which issued an injunction permanently restraining the seller and his new business from soliciting the sold business's customers who were being serviced by the sold business at the time of sale.

The *Mohawk* court reasoned that a permanent injunction was proper because the sale of the business included the business's goodwill, which gave the buyer a "vested property right" in the expectation that the seller would "do everything within his power to transfer the loyalties of his customers to [the buyer]."

> Named after the New York Court of Appeals' decision in *Mohawk Maintenance Co. v. Kessler*,[2] the *Mohawk* doctrine imposes a permanent covenant on the seller of a business not to solicit the seller's former customers when the sale of the business includes its "good will."

Notably, the *Mohawk* court distinguished the nonsolicitation obligations that arise upon the sale of goodwill from a covenant not to compete. The court stated that a covenant not to compete arises only "out of an express agreement" and is subject to a reasonableness test under New York law.

This statement is consistent with the majority rule that noncompetition covenants must be reasonable in scope and duration and no broader than necessary to protect an employer's legitimate business interests.[2]

In contrast, the court stated that the implied covenant not to solicit former customers following a sale of goodwill "imposes a much narrower duty" than covenants not to compete, and that the implied nonsolicitation covenant imposed by New York law is "inherently reasonable notwithstanding its infinite duration."[3]

DEVELOPMENT AND SCOPE OF THE *MOHAWK* DOCTRINE

Recent decisions have confirmed that the *Mohawk* doctrine is now established law in New York.[4] As discussed below, while a number of cases have clarified the scope of the doctrine, open questions remain.

A contract for the sale of a business can include the business's goodwill even if the contract does not expressly provide as such.

In *Mohawk*, the court found that the circumstances of the sale demonstrated that a transfer of goodwill was intended "even though the contract of sale did not expressly provide as much."[5]

In so finding, the court specifically focused on the amount of the purchase price and the fact that the seller had agreed to an express noncompetition covenant following the sale.[6]

These factors are likely not exhaustive, and it is important for parties to a sale agreement governed by New York law to understand that a court will look to the totality of the circumstances surrounding the sale to determine whether goodwill was included, regardless of whether the sale agreement expressly provides as such.

Private equity sponsors seeking to avoid business and litigation risks caused by the potential applicability of *Mohawk* should consider specifically addressing or limiting the seller's non-solicitation obligations in sale agreements governed by New York law.

A seller's obligations under the *Mohawk* doctrine can be modified by a written agreement imposing less onerous nonsolicitation restrictions.

Numerous courts interpreting the doctrine have found that the permanent nonsolicitation covenant imposed by New York law does not apply where the parties expressly agree in a contract for sale of a business to less onerous nonsolicitation restrictions on the seller.[7]

For example, in *MGM Court Reporting Service Inc. v. Greenberg*, the New York Court of Appeals cited its decision in *Mohawk* in finding that the implied permanent nonsolicitation covenant did not apply where the parties signed a written agreement that expressly limited the nonsolicitation obligations of a seller to three specific customers of the sold business.[8]

Note, however, that an express noncompetition covenant alone is unlikely to alter a seller's nonsolicitation obligations under *Mohawk*. Indeed, the sale agreement in *Mohawk* included a five-year noncompetition provision but was silent as to any nonsolicitation obligations.

As discussed above, the *Mohawk* court permanently banned the seller from soliciting his former customers, notwithstanding the limited scope of the five-year noncompete.

The *Mohawk* doctrine does not preclude a seller's acceptance of unsolicited patronage by former customers.

The *Mohawk* court did not restrain the seller or his new business from accepting the patronage of former customers who voluntarily chose to trade with the seller's new business without prompting or solicitation by the seller.

The court expressly acknowledged that, following a sale of a business, the attempted transfer of goodwill may not be entirely successful and that some of the business's customers may choose to do business elsewhere.

The court found it to be "quite another matter, however, when the seller actively interferes with the purchaser's relationship with his newly acquired customers by capitalizing upon their personal loyalties to him in an effort to recapture their patronage."

The court made clear that its ruling permanently enjoining the seller was limited to such active solicitation.[9] As discussed below, the question of whether the seller is actively soliciting customer relationships is a complex factual inquiry.

The meaning of "solicitation" is determined on a case-by-case basis for purposes of the *Mohawk* doctrine.

In *Bessemer Trust Co. v. Branin*,[10] the U.S. Circuit Court of Appeals for the 2nd Circuit certified to the New York Court of Appeals the question of what degree of participation in a new employer's solicitation of a seller's former customers constitutes improper solicitation by the seller under the *Mohawk* doctrine.

In *Bessemer*, the defendant sold his shares in a wealth management firm, including the firm's customer accounts and goodwill, to the plaintiff.

The defendant later joined a competitive wealth management firm. At the new firm, he responded to factual questions raised by his former customers. He also sat in on a meeting with a former customer and the new employer, although he "essentially played no role in the meeting."

In answering the certified question, the New York Court of Appeals declined to create any "hard and fast" rule on what constitutes solicitation under the *Mohawk* doctrine.

Instead, the *Bessemer* court instructed that the determination should be made on a case-by-case basis considering "the principles underlying the rule in *Mohawk* and the factors involved within the relevant industry that may impair the goodwill conveyed by the original seller."

Under the specific facts in *Bessemer*, the court considered, inter alia, whether the seller initiated contact with his former customers. The court expressly noted that the *Mohawk* doctrine bars a seller of goodwill from taking affirmative steps to "directly communicate" with former customers.

The court found that a seller of goodwill may answer factual inquiries of a former customer so long as the seller's responses do not go beyond the scope of the specific information sought and the seller does not disparage the purchaser of his former business.[11]

The *Mohawk* doctrine applies only to "voluntary" sellers, but the precise meaning of "voluntary" remains unclear. The *Mohawk* court based its decision in part on a decision issued in 1910 by the New Court of Appeals in *Von Bremen v. MacMonnies*.[12]

In *Von Bremen*, the court distinguished goodwill that is the subject of a voluntary sale of a business from goodwill sold under compulsion and found that New York law imposes a nonsolicitation obligation only when goodwill is sold pursuant to a "free affirmative act."[13]

Recent New York cases have confirmed that the *Mohawk* doctrine applies only to "voluntary" sellers of goodwill.

For example, in *Autz v. Fagan,* the New York Supreme Court confirmed this principle and found that a transfer of shares resulting from an involuntary dissolution proceeding was a sale made under compulsion and did not implicate or include any implied nonsolicitation covenant.[14]

The precise meaning of voluntariness for purposes of the *Mohawk* doctrine is not fully developed. In *Mar-Cone Appliance Parts Co. v. Mangan*,[15] the defendant had been a minority shareholder in a business that the controlling shareholders sold without consulting him.

The defendant's shares were sold pursuant to a drag-along provision in a stockholder's agreement. The purchaser of the business brought suit against the defendant after he joined a competing firm and began soliciting his former customers.

The defendant argued that the nonsolicitation duties imposed by the *Mohawk* doctrine did not apply to him because he had not engaged in a voluntary sale of his former business.

The court decided the case on other procedural grounds, and the question of whether a drag-along sale constitutes a voluntary sale implicating the *Mohawk* doctrine remains open.

The *Mohawk* doctrine applies only under New York law. It has not been expressly adopted in any other jurisdictions, though an even broader Massachusetts doctrine imposes a ban on competition following the sale of a business's goodwill.[16]

Delaware has neither adopted nor rejected the *Mohawk* doctrine.[17] This is noteworthy because parties to private equity M&A transactions often choose Delaware law to govern their agreements.

The public policies of other states (such as California's general prohibitions against noncompetition types of agreements) could intersect and limit the applicability of the *Mohawk* doctrine in certain instances.

Potential impact on private equity sponsors

We are not aware of any published cases applying the *Mohawk* doctrine to private equity transactions.

Thus, it is not clear precisely how New York courts would interpret and apply *Mohawk* and its progeny in the context of a private equity sponsor's purchase or sale of a portfolio company. The question of whether a private equity seller may be burdened by additional restrictions on top of any noncompete or similar restriction included in the sale agreement remains open.

Private equity sponsors seeking to avoid business and litigation risks caused by the potential applicability of *Mohawk* should consider specifically addressing or limiting the seller's nonsolicitation obligations in sale agreements governed by New York law.

Private equity sponsors concerned about whether they may be subject to the *Mohawk* doctrine, or that might have an offensive claim under the doctrine, should also consider retaining experienced counsel to advise on the sponsor's rights and obligations.

Notes

[1] 419 N.E.2d 324 (N.Y. 1981).

[2] The specific requirements for enforceability of noncompetition and other employment restrictive covenants vary by jurisdiction. A state-by-state survey of the requirements for enforceability of such restrictive covenants is beyond the scope of this commentary.

[3] *Id.* at 328-29 (internal citations omitted).

[4] *See, e.g., GlaxoSmithKline LLC v. Laclede Inc.*, No. 18-cv-4945, 2019 WL 293329, at *5 (S.D.N.Y. Jan. 23, 2019); *Trimm v. Freese*, 51 Misc. 3d 1217(A), 38 N.Y.S.3d 833 (N.Y. Sup. Ct. 2016); *Bessemer Tr. Co. v. Branin*, 949 N.E.2d 462, 465-66 (N.Y. 2011).

[5] 419 N.E.2d at 330.

[6] *Id.* The *Mohawk* court was not asked to determine the enforceability of the seller's noncompetition covenants. Rather, the issue on appeal was limited to the "narrow question of the propriety of the lower court's direction that [the seller and his new business] refrain indefinitely from soliciting" the seller's former customers. *Id.* at 327.

[7] *See, e.g., Juniper Entm't Inc. v. Calderhead,* C.A. No. 07-cv-2413, 2007 WL 9723385, at *14 (E.D.N.Y. Aug. 17, 2007); *MGM Court Reporting Servs. Inc. v. Greenberg,* 541 N.E.2d 405, 406 (N.Y. 1989); *CSI Group LLP v. Harper,* 153 A.D. 3d 1314, 1318 (N.Y. Sup. Ct. 2017); *Titus & Donnelly Inc. v. Poto*, 205 A.D. 2d 475 (N.Y. Sup. Ct. 1994); *but see Misys Int'l Banking Sys. Inc. v. TwoFour Sys. LLC*, 800 N.Y.S.2d 350 (N.Y. Sup. Ct. 2004).

[8] 541 N.E.2d at 406 (N.Y. 1989).

[9] 419 N.E.2d at 329-330.

[10] 949 N.E.2d 462 (N.Y. 2011).

[11] *Id.* at 469-70.

[12] 93 N.E. 186 (N.Y. 1910).

[13] *Id.*

[14] 16 Misc.3d 1140(A), at *4 (N.Y. Sup. Ct. 2007).

[15] 879 F. Supp. 2d 344 (W.D.N.Y. 2012).

[16] *See United Tool & Indus. Supply Co. v. Torrisi*, 356 Mass. 103 (1969) ("after a voluntary sale of good will the seller cannot engage in a competing business which will derogate from that sale."). The contours of this Massachusetts doctrine are beyond the scope of this commentary.

[17] *See Fulk v. Wash. Serv. Assocs. Inc.*, No. 17747, 2002 WL 1402273, at *12 (Del. Ch. June 21, 2002).

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