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Non-Disclosure Provisions in Settlement Agreements

By Jeffrey S. Klein, Nicholas J. Pappas and Justin M. DiGennaro

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In response to the #MeToo movement, a number of state legislatures and Congress have enacted legislation to address their concerns regarding sex-based inequities in the workplace (see [Weil's July 2019 Employer Update](#)). One area of particular focus has been the use of non-disclosure provisions in settlement agreements that resolve allegations of sexual harassment, other forms of harassment, and discrimination. Critics of non-disclosure provisions argue that employers who have used these types of provisions may inadvertently promote a culture of silence around sexual harassment and sex-based discrimination in the workplace, thus enabling the individual perpetrators of harassment and discrimination to avoid accountability. On the other hand, many employers legitimately use non-disclosure provisions to protect the victims of harassment and discrimination, as well as to avoid negative publicity resulting from non-meritorious claims. Without the protection of a non-disclosure agreement, employers may more frequently elect to contest such non-meritorious claims of discrimination or harassment to avoid negative publicity emanating from a publicly disclosed settlement.

The federal government and several state governments have enacted legislation concerning non-disclosure provisions in settlement agreements, adopting varied approaches to the issue, in ways that affect an employer's incentives and strategic options. In this article, we review the federal tax legislation concerning the deductibility of settlement payments for sexual harassment claims. Next, we review the varied legislative approaches that several states have taken to the issue of non-disclosure provisions in settlement agreements. Finally, we offer a number of practical considerations for employers in light of the current legal landscape.

Federal Tax Deductibility

In the 2017 Tax Cuts and Jobs Act, Congress amended federal tax law regarding the deductibility of costs associated with settlements and attorney's fees concerning certain types of claims. 26 U.S.C. § 162(q). Specifically, the tax law now states that, "no deduction shall be allowed under this chapter for any settlement or payment related to sexual harassment or sexual abuse **if such settlement or payment is subject to a nondisclosure agreement** . . ." 26 U.S.C. § 162(q)(1) (emphasis added). The law also prohibits deduction of any "attorney's fees related to such a settlement or payment." 26 U.S.C. § 162(q)(2). The IRS has yet to issue guidance on the reach of the "related to" language in this section. For example, does this language encompass a

general release of claims, which may include a release of sexual harassment claims, even when the employee has never asserted any specific allegations of sexual harassment? Even if the prohibition applies only to instances in which the employee has made a specific claim of sexual harassment, employers face greater expense in resolving such claims if the settlement involves employee non-disclosure obligations than if the employer resolves such claims without such obligations.

Varying State Approaches

A number of states have passed legislation geared towards prohibiting the enforcement of non-disclosure provisions in settlement agreements that resolve allegations of sexual harassment, other forms of harassment, or discrimination. These states have taken different approaches towards the issue.

For example, New York enacted the first state-wide law in the nation concerning this subject, mandating that “for any claim or cause of action . . . the factual foundation for which involves sexual harassment . . . no employer . . . shall have the authority to include or agree to include in [a settlement agreement] any term or condition that would prevent the disclosure of the underlying facts and circumstances to the claim or action **unless the condition of confidentiality is the plaintiff’s preference.**” N.Y. Gen. Obligations Law 5-336 (emphasis added). Earlier this month, New York enacted additional legislation expanding this provision to cover all claims of “discrimination,” and not just “sexual harassment.” 2019 NY S.B. 6577 / 2019 NY A.B. 8421.

To satisfy the “plaintiff’s preference” exception, an employee “shall have twenty-one days to consider” an agreement containing a non-disclosure provision, and even where the employee executes the agreement because such a provision “is the plaintiff’s preference,” the employee will be permitted to “revoke the agreement” for a period of seven days after the employee’s execution. N.Y. Gen. Obligations Law 5-336. New York State’s website containing answers to Frequently Asked Questions about this provision states that “the parties will need to enter into two separate documents providing for nondisclosure:

1) an agreement that memorializes the preference of the person who complained, and 2) whatever documents incorporate that preferred term or condition as part of a larger overall resolution between the parties” (see <https://www.ny.gov/combating-sexual-harassment-workplace/combating-sexual-harassment-frequently-asked-questions#for-employers>). While the New York law offers employers the opportunity to secure a binding non-disclosure commitment from their employees, there are still a number of procedural hurdles required to satisfy the elements of the “plaintiff’s preference” exception.

On March 18, 2019, New Jersey enacted a law stating that, “[a] provision in any . . . settlement agreement which has the purpose or effect of concealing the details relating to a claim of discrimination, retaliation, or harassment . . . shall be deemed against public policy and unenforceable against a current or former employee . . . who is a party to the . . . settlement.” N.J.S.A. 10:5-12.8(a). The New Jersey law extends beyond claims of sexual harassment, to include all claims of “discrimination, retaliation, or harassment,” thereby encompassing a wider array of unlawful conduct concerning non-sex-based forms of harassment and discrimination. Significantly, the New Jersey law contains no exceptions to this prohibition, meaning that there are no circumstances under which an employer can bind an employee to non-disclosure obligations in a settlement agreement resolving these types of claims.

California has taken a similar approach, enacting legislation which states that, “a provision within a settlement agreement that prevents the disclosure of factual information related to a claim filed in a civil action or a complaint filed in an administrative action, regarding [certain types of claims] is prohibited.” Cal. Civ. Pro. § 1001(a). The types of claims covered by this prohibition involve “[a]n act of sexual harassment,” “[a]n act of workplace harassment or discrimination based on sex,” “failure to prevent an act of workplace harassment or discrimination based on sex,” or “an act of retaliation against a person for reporting harassment or discrimination based on sex.” Cal. Civ. Pro. § 1001(a)(2) & (a)(3). To the extent that an employer includes such a provision, that provision will

be “void as a matter of law and against public policy.” Cal. Civ. Pro. § 1001(d). Unlike the New Jersey law, the California law applies only to harassment, discrimination, and retaliation related to an employee’s sex, as opposed to harassment, discrimination, and retaliation based upon other protected characteristics. The California law also requires the employee to have asserted the claim in a civil or administrative action, whereas the New Jersey law does not.

The California law also contains another important distinction from the New Jersey law. Similar to the New York law, the California law states that “a provision that shields the identity of the claimant and all facts that could lead to the discovery of his or her identity . . . may be included within a settlement agreement **at the request of the claimant.**” Cal. Civ. Pro. § 1001(c) (emphasis added). While the law provides little clarity as to what it means by “all facts that could lead to the discovery” of the employee’s identity, or the “request of the claimant,” at minimum, this language creates the possibility for binding employee non-disclosure obligations in settlement agreements under certain circumstances.

Effects of Legislation

Needless to say, all employers, especially those with operations in multiple jurisdictions, should stay current regarding legislative developments that affect their ability to secure non-disclosure commitments from their employees in settlements agreements. These developments will influence both the structuring of settlements concerning certain types of claims as well as the ultimate decision of whether to settle those claims in the first place.

For example, in light of the ambiguity concerning whether Section 162(q) of the 2017 Tax Cuts and Jobs Act applies to a general release of claims, employers should consider adding language in their settlement agreements to address the question whether any portion of the consideration paid in a settlement constitutes “any settlement or payment related to sexual harassment or sexual abuse.” If an employee has never asserted such a claim, employers may consider adding an acknowledgement

that only a *de minimis* portion of any payment to the employee is consideration for a release of any claims of sexual harassment or sexual abuse. To the extent a settlement *does* include a release of any claims of sexual harassment or sexual abuse, the employer may seek to segregate the consideration paid to the employee for the settlement of the sexual harassment or sexual abuse claims. Such an arrangement will permit the employer to require a non-disclosure commitment from the employee but also will allow the employer to continue to deduct at least some portion of the settlement cost from its federal taxes.

Because employee non-disclosure commitments may be included in settlement agreements in California or New York only if included “at the request of the claimant” or “plaintiff’s preference,” employers in those states may need to reassess their negotiating approach towards complaining employees concerning the mutual desirability of non-disclosure commitments in settlement agreements. In many instances, employees will be amenable to non-disclosure provisions for privacy or other reasons. In cases where the parties agree to confidentiality, New York employers should consider presenting and executing a separate non-disclosure commitment from the employee before negotiating and executing the overarching settlement agreement. In cases where executing a separate agreement is impractical, employers should consider whether the directive in the FAQs is actually consistent with New York law, which contains no requirement for a separate agreement. If the parties agree that no separate agreement is required, parties to a settlement in New York should consider a simple acknowledgement in the settlement agreement that confidentiality is the employee’s preference, that the employee had 21 days to consider the confidentiality provision, and that the employee had 7 days to revoke it.

Because the California law limiting the enforceability of non-disclosure provisions only applies once an employee has filed a civil or administrative action, if possible, California employers should assess the desirability of settlement earlier. If a California employer is able to settle a claim before the commencement of an action, the employer will have

much greater flexibility with respect to employee non-disclosure obligations than it would have after the commencement of an action.

Finally, because New Jersey employers cannot, under any circumstances, secure non-disclosure commitments from their employees in settlements of discrimination, retaliation, and harassment claims, the risk of negative publicity associated with such claims will exist even if the parties reach a settlement. As a result, New Jersey employers may wish to assess with their counsel the viability of their employees potentially waiving the New Jersey law prohibiting confidentiality and/or the parties choosing the law of a different state to govern the agreement where a reasonable basis for such other jurisdiction exists. Absent the protection of a confidentiality provision, New Jersey employers should understand that their settlements may become public. In those cases, New Jersey employers will need to weigh the new calculus regarding the pros and cons of settlement with the risk of negative publicity in mind.

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UK Supreme Court Clarifies the Correct Approach to the Severability of Unenforceable Post-Employment Restrictions

By Ivor Gwilliams

In an eagerly awaited judgment, in the case of *Tillman v Egon Zehnder [2019] UKSC 32*, the Supreme Court in the United Kingdom has clarified the correct approach to the severability of unenforceable post-employment restrictions, in order to uphold a non-compete restriction in favour of an employer. The non-compete restriction in question required the departing employee not to “directly or indirectly engage or be concerned or interested in” any competing business for six months after the termination of their employment. The Supreme Court held that the words ‘interested in’ were too wide to be enforceable, but could be severed, leaving the remainder of the restriction intact and enforceable.

Aside from being exciting for employment lawyers (this being the first employment restrictive covenant case to be considered by the Supreme Court in over 100 years), the decision is welcome news for employers. It also serves as a reminder of the need for employers to ensure that the post-employment restrictions in their employment contracts are properly drafted so as to safeguard, as far as possible, the enforceability of such restrictions.

Background

In order to enforce any covenant that restricts an employee’s activities after the termination of their employment, an employer will need to demonstrate that it has a legitimate proprietary interest that is appropriate to protect (such as confidential information, customer relationships / goodwill or the stability of the workforce) and that the covenant is no wider than is necessary to protect that interest. Otherwise, the covenant will be void as a matter of public policy for being in restraint of trade. The English courts will seek to balance the competing interests of the parties (i.e. the employer’s need for protection against the employee’s need to use their

skills and knowledge in order to earn a living) and, in doing so, will consider whether there is a less onerous form of protection available to the employer. For this reason, post-employment non-compete restrictions are, generally speaking, considered to be more difficult to enforce than, say, non-solicitation, non-dealing and/or confidentiality restrictions.

In order to ensure that a post-employment non-compete restriction is no wider than necessary, such a restriction typically includes an express 'carve-out' allowing the departing employee who is subject to the restriction to hold minority shareholdings in other companies (e.g. of up to, say, 3% or 5% of a company's issued share capital) for personal investment purposes. The aim of such a 'carve-out' is to ensure that the restriction is not held to be unenforceable because it is so wide as to prevent the departing employee from holding such passive investments.

In this case, the employer, Egon Zehnder Ltd (**Egon Zehnder**), sought to enforce a restriction against a departing employee, Ms Tillman, which stated that Ms Tillman could not "directly or indirectly engage or be concerned or interested in any business carried on in competition with any of the businesses" of Egon Zehnder for a six-month period following the termination of her employment. This case is important, not least because this standard wording has long been used by employers in the UK. Ms Tillman contended that the restriction was an unreasonable restraint of trade. Specifically, Ms Tillman argued that the words 'interested in' were so wide as to prevent her from holding even a minority shareholding in a competitor, which would be an unreasonable restraint of trade and, therefore, that the entire non-compete restriction was void (whether or not she had any intention of holding such an interest was agreed to be irrelevant). Ms Tillman's non-compete restriction did not contain the typical 'carve-out' described above.

The issues for the Supreme Court were: (i) whether the doctrine of restraint of trade was engaged by a restriction on post-employment shareholding (Egon Zehnder argued that it was not); (ii) the proper construction of the phrase 'interested in' in a non-

competition covenant; and (iii) the correct approach to the doctrine of severance of a non-competition covenant and whether it permitted the severance of the phrase 'interested in' and/or the phrase 'concerned in.'

On point (i), the Supreme Court held that the doctrine of restraint of trade was engaged and on point (ii), the Supreme Court agreed with Ms Tillman (and the preceding Court of Appeal decision) that the words 'interested in' did cover a shareholding, whether large or small, and therefore the non-compete restriction would be unenforceable unless the words 'interested in' could be validly severed from the remainder of the restriction. Therefore, the key issue for the Supreme Court was point (iii), i.e. whether the words 'or interested' could be severed (the Supreme Court decided that it did not need to consider whether the words 'concerned in' could be severed as they were not wide enough to cover passive shareholdings).

The Severability Question

It has long been established that, in certain circumstances, it is possible for the courts to remove or sever wording which is unreasonable (and therefore unenforceable) from an otherwise reasonable and enforceable restriction.

However, for public policy reasons, the courts have traditionally been cautious when applying this doctrine. The Court of Appeal in *Attwood v Lamont* [1920] 3 KB 571 decided that the doctrine could not be used in that case. The approach taken by the court in that case was that severance of an unenforceable provision is only permissible "where the covenant isn't really a single covenant but is in effect a combination of several distinct covenants." In other words, different parts of a single covenant cannot be severed. Also, the court in that case determined that the part to be removed must be no more than trivial or technical.

A less restrictive approach was taken by the Court of Appeal in its decision in the more recent case of *Beckett Investment Management Group Ltd v Hall* [2007] EWCA Civ 613, following two earlier cases in the 1980s and 1990s. The court in that case endorsed a three-point test for severability: (i) the unenforceable provision must be capable of being removed without

the necessity of adding to or modifying the wording of what remains (the so-called ‘blue pencil’ test); (ii) the remaining terms must continue to be supported by adequate consideration; and (iii) the removal of the unenforceable provision must not so change the character of the contract that it becomes “not the sort of contract that the parties entered into at all.”

In *Tillman v Egon Zehnder*, the Supreme Court overturned the decision of the Court of Appeal in the 1920s case of *Attwood v Lamont* and re-affirmed the three-point test endorsed in the *Beckett Investment Management Group Ltd v Hall* case, except that it reframed the crucial, third criterion as being “whether removal of the provision would not generate any major change in the overall effect of all the post-employment restraints in the contract,” pointing out that “it is for the employer to establish that its removal would not do so.” In reframing this third criterion, the Supreme Court has possibly made this criterion easier for employers to satisfy, although time (and further litigation) will tell. (The Supreme Court also noted that in a situation where an employer asks the court to sever part of a post-employment restriction, the second criterion can essentially be ignored because, in such a situation, the employer is not seeking to reduce the consideration passing from the employer to the employee.)

The Supreme Court was, therefore, able to rule in the employer’s favour that: (i) the words ‘or interested’ were capable of being removed from the post-employment non-compete restriction without the need to add to or modify the wording of the remainder of the restriction; and (ii) the removal of the prohibition against Ms Tillman being “interested” would not generate any major change in the overall effect of the restriction.

Practical Tips

We set out below some practical tips and lessons for employers of UK-based employees, following this case:

- Employers should continue to ensure that the post-employment restrictions they include in their employment contracts are no wider than necessary to protect their legitimate interests and are tailored

to each employee or category of employee. The Supreme Court decision in this case should not be seen as a green light for employers in the UK to impose post-employment restrictions they suspect may be unenforceable, in the supposedly safe knowledge that the UK courts will sever such restrictions if they are not enforceable. There can be no guarantee that the UK courts will do so. To take such an approach risks unnecessary, uncertain and expensive litigation. It is still advisable for an employer to ask itself – what is the minimum set of restrictions (in terms of scope, duration, etc.) that is necessary to protect my business, rather than, what is the most fulsome protection I can enforce? Also, the Supreme Court suggested that there may be adverse legal cost consequences for employers who are responsible for litigation as a result of including unenforceable restrictions that need to be cleaned up by the courts.

- The UK courts will not (unlike certain other jurisdictions) re-write post-employment restrictions to make them enforceable. For example, the UK courts will not reduce the duration of such a restriction to make it enforceable. Only certain jurisdictions, such as certain Australian States, allow employers to use a ‘cascading’ series of post-employment restrictions that are stated to last, say, 12 months following termination of employment or, alternatively, if 12 months is not enforceable, then nine months, or, alternatively, if nine months is not enforceable, then six months, etc.
- Employers should make sure that they consider carefully whether to include a ‘carve-out’ in non-compete restrictions which permits the employee to hold minority interests in other companies for personal investment purposes, particularly if using the words ‘interested in’ in the non-compete clause or other wording which would potentially prohibit the holding of such minority interests. In many cases, it will be sensible to do so. Often these carve-outs only extend to minority interests in listed companies but, to be safe, employers should consider extending such carve-outs to minority

interests in unlisted as well as listed companies. Also, employers should make sure that the carve-out which allows the holding of such minority interests after the employment has ended is no less generous than any such carve-out that applies during employment.

- Where practicable, employers should separate each restriction into different sub-clauses so that it is easier for the UK courts to sever any unenforceable restrictions. Also, employers should remember to include a clause which expressly permits severance of unenforceable restrictions, even if such a clause is not a prerequisite for the UK courts to apply the 'blue pencil' doctrine.

- Employers should, periodically, review the post-employment restrictions that their employees are subject to. Such restrictions may need to be updated when an employee is promoted or simply because the passing of time has rendered the restrictions no longer appropriate for the business or the employee's particular role. If the restrictions do need to be redrafted, then employees should be given some form of consideration for agreeing to the amended restrictions, e.g. a one-off bonus or a salary rise or some other benefit to ensure, so far as is possible, the enforceability of the amended restrictions.

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If you have questions concerning the contents of this issue, or would like more information about Weil's Employment Litigation and Executive Compensation & Benefits practices, please speak to your regular contact at Weil, or to the editors or practice group members listed below:

Practice Group Members:

Jeffrey S. Klein
Practice Group Leader
New York
+1 212 310 8790
jeffrey.klein@weil.com

Frankfurt
Stephan Grauke
+49 69 21659 651
stephan.grauke@weil.com

London
Ivor Gwilliams
+44 20 7903 1423
ivor.gwilliams@weil.com

Miami
Edward Soto
+1 305 577 3177
edward.soto@weil.com

New York
Sarah Downie
+1 212 310 8030
sarah.downie@weil.com

Gary D. Friedman
+1 212 310 8963
gary.friedman@weil.com

Steven M. Margolis
+1 212 310 8124
steven.margolis@weil.com

Michael Nissan
+1 212 310 8169
michael.nissan@weil.com

Nicholas J. Pappas
+1 212 310 8669
nicholas.pappas@weil.com

Amy M. Rubin
+1 212 310 8691
amy.rubin@weil.com

Paul J. Wessel
+1 212 310 8720
paul.wessel@weil.com

Silicon Valley
David Singh
+1 650 802 3010
david.singh@weil.com

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