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Précis Paper

Restraints of Trade

This is a presentation by two experienced employment law practitioners discussing restraints of trade in employment contracts and important considerations in light of the changing nature of the workplace.

Discussion Includes

- Nature of restraints of trade and drafting considerations
- The changing nature of the workplace and data contained in social media
- Legitimate business interests
- Enforcing restraints – sticks and carrots
- Effect of contractual repudiation on enforcement of restraints
- Fixed term contracts
- Equitable remedies

Précis Paper

Restraints of Trade

1. In this edition of BenchTV, Danny King (Director, DLK Legal, Sydney) and Michael Doherty (Principal, Michael Doherty Legal, Sydney) discuss restraints of trade in employment contracts.

Nature of Restraints of Trade and Drafting Considerations

2. In the employment law context, a restraint of trade is a contractual obligation that the employee signs up to in which he or she promises not to do certain things after the employment relationship has ended. The traditional concept of a restraint of trade is that it must be in a contract and must only go so far as is reasonable and necessary to protect the legitimate business interests of the employer. The periods for restraints were traditionally limited to approximately two years.

3. There are two types of restraints: first, a non-solicitation clause which prevents an employee from expropriating things (including clients or client lists) from the employer; and second, a non-compete clause.

4. Traditionally, restraints were considered to be void for public policy reasons. However, the approach of courts to restraints is changing and Ms King considered that restraints are more enforceable than previously, particularly in NSW.

5. Restraints are generally drafted in a cascading drafting style, which allows the judge to make provision as to what would be reasonable at the time of enforcement. For example, the geographical area or time period for the restraint will be drafted in a way that would allow a judge to apply the "blue pencil test", and cross out the areas and durations of the restraint that are not reasonable at the end of the relationship.

The Changing Nature of the Workplace

6. With the changing nature of the workplace and the increasing proportion of Gen-Y and Millennials in the workplace, the exposures that employers are faced with today are different from that with older generations of employees. This may impact what is enforceable in a restraint of trade context.

7. In the social media sphere, a tool such as LinkedIn can give an employee access to an entire database that is attached to a particular person rather than an employer. An employer may therefore need to consider how to lock down an employee's uses of social media networks

after they leave their employment, as the social media assets generated in the course of employment may have the potential to cause harm to the employer down the track.

8. Some companies are therefore attempting to require employees to delete social media accounts at the end of the employment, whereas others are defining social media contacts as being subject to the restraint itself.

9. The confidentiality provisions in employment contracts are closely linked to restraints of trade, however confidentiality issues are often dealt with by direct clauses in the employment contract.

Considerations in Enforcing Restraints

10. To enforce a restraint of trade, the court looks at what is reasonable in the circumstances of the termination, and what the legitimate business interests are that the restraint is trying to protect.

11. The employee may have access to confidential information or business relationships by virtue of their former position. These are relevant when considering the legitimate business interests of the employer. A legitimate business interest can include the number of relationships, including important client relationships and employment relationships with colleagues or suppliers, that the employee has cultivated.

12. When determining what is reasonably necessary to protect the legitimate interests of the employer, the judge will consider what is reasonable at the time and will invalidate any provisions relating to time or geography that are too extreme.

13. The onus of enforcing the restraint lies with the party seeking to enforce the restraint.

14. As a general rule, it is a two-step process to enforce the restraint of trade. First, when the employer becomes aware of conduct that may breach the restraint, it would serve notice asking the former employee to cease their actions. If this attempt is unsuccessful, the employer can seek an injunction in the Supreme Court. Often, matters will conclude at this stage as it may become prohibitively expensive to continue proceedings beyond the injunction phase. The next formal stage would be breach of contract proceedings in the Supreme Court, where damages can be awarded.

15. Practitioners advising employers should be aware that time is of the essence, and materials for the application for urgent injunctive relief should be prepared quickly.

16. In NSW, the *Restraints of Trade Act 1976* (NSW) allows the courts to rewrite a post-employment restraint clause if they consider it to be appropriate to do so. The Act allows judges to write words into restraints of trade, and therefore make a decision about what is

reasonable in the circumstance, even where the restraint is completely unreasonable. This makes it difficult for any employer or employee to determine in advance the best or worst case outcome, and therefore underlies the importance of employers trying to convince employees not to breach restraints, without requiring the intervention of the court.

17. Employers are increasingly looking at ways to manage the relationship with outgoing employees with a more positive frame of mind. Ms King advised that rather than relying on this "stick" in enforcing restraints of trade, many employers are now considering innovative "carrots". This could include the employer providing consideration in the form of a payment that is attached to the restraint in question, such as continuing to pay a salary for a period of time if the employee does not breach the restraint. On a legal level, there is a greater chance of enforcing a restraint of trade where there is a payment made to the employee. On a practical level, the kind of employees who are subject to restraints are leveraged and have financial commitments, and will be less inclined to breach their contract if they are being provided with a financial incentive.

18. Types of consideration that could be offered include:

    - An election for the employer to make as to whether they wish to pay an amount of consideration. The employer could therefore determine whether to pay the consideration based on their analysis of the risk that the outgoing employee poses to the business.
    - An incentive payment to be paid at the end of the restraint.

19. In contrast, "sticks" can be inserted into contracts in the form of punitive clauses if a restraint is breached. For example, a liquidated damages clause could be used, in which the contract would provide for a financial penalty payable by the employee if they act in breach of the restraint. In order to ensure that the provision is not interpreted as a penalty, damages must be a reasonable pre-estimation of the actual damage or loss that will be suffered by the employer. Traditionally, this has been a set percentage of the revenue from a particular client that is lost.

20. In *Birdanco Nominees Pty Ltd v Money* [2012] VSCA 64, a financial services employee subject to a liquidated damages clause was ordered to pay $188,000 for having breached the restraint of trade. This was a 75 percent cut of the fees that the client had spent with the employer in the previous financial year.

<u>Issues in the Enforceability of Restraints</u>

21. In *Fishlock v The Campaign Palace* [2013] NSWSC 531, the employer had hired someone else to perform the majority of Mr Fishlock's duties. Mr Fishlock accepted the employer's repudiation in these circumstances. The Court held that where an employee has accepted a

repudiation of contract, the employer is unable to rely on what would otherwise be a valid restraint.

22. Another area that has arisen in the caselaw is in relation to fixed term contracts. In *BGC Partners (Australia) Pty Ltd v Hickey* [2016] NSWSC 90, Mr Hickey was engaged on a fixed term contract that was due to expire in 2018. The contract contained a six month non-compete restraint.

23. Mr Hickery purported to give one month's notice of termination of the employment, in accordance with the applicable award. However, his employment contract was very specific about how it could be terminated and contained a three month notice period that could be exercised at a particular point towards the end of the contract's term. Mr Hickey argued that he must be able to provide reasonable notice of termination under the contract.

24. The Court disagreed. In the interlocutory proceedings, Stevenson J upheld the contract between BGC and Hickey, finding that Hickey was not entitled to terminate the contract in the manner he had attempted – but that the attempt itself was repudiatory, thus allowing the innocent party to elect whether to affirm the contract or accept that repudiation. As BGC clearly affirmed the contract, his Honour found that Hickey continued to be bound by the contract, including certain of the restraints, and ordered a nine month injunction. The injunction covered six months for the restraint and three months in the nature of specific performance. This decision provides an indication of the changing law of restraints, as traditionally specific performance would never be ordered in relation to the performance of an employment contract.

Equitable Remedies

25. Even where there is no restraint contained in the employment contract, an employer has some avenues for restraining post-employment conduct. In *Andrews Advertising Pty Ltd v David Andrews* [2014] NSWSC 318, the former employee was found to be in breach of his fiduciary duties owed to his employer when he continued to service former clients. It was the pre-employment conduct that made his hands unclean, and resulted in the post-employment profits having to be accounted for.

26. In addition, in equity, an employee must not take the confidential information of an employer and use it as a 'springboard' to engage in competition with their previous employer (see for example *Ansell Rubber Co Pty Ltd v Allied Rubber Industries Pty Ltd* [1967] VR 37). However, the Court is reluctant to use the springboard principle where there is an enforceable restraint of trade.

Considerations for New Employers

27. Often, a new employer will agree to indemnify the employee in the case of the old employer seeking to enforce their restraint of trade. However, employers should be aware of the danger of this type of action.

28. First, the employer could be considered to be an accessory to the breach of contract. In *Wilson HTM Investment Group Limited v Pagliaro* [2012] NSWSC 1, a new employer was found to be an accessory to the breach of contract by the employee.

29. Second, the employer could be exposed to future costs orders. In *HRX Pty Ltd v Scott* [2013] NSWSC 451, the employer offered to pay the legal fees of Mr Scott, the employee. When it became clear that Mr Scott had taken confidential information before the end of his former employment, the new employer withdrew its support. However, the employer was still ordered to pay the costs of the case, as the Court found that the litigation would not have existed were it not for the new employer bankrolling the employee.

30. Employers should always ask whether new employees are subject to any contractual restraints. Moreover, there should be a warranty included in the employment contract that the employee warrants that they are not subject to any restraints of trade or other contractual obligations that have not been disclosed. The employee should also undertake not to do anything to jeopardise the new employer, such as the use of confidential information.

BIOGRAPHY

Danny King

Director, DLK Legal, Sydney

Danny King was admitted into practice in 2007 and started her career with top-tier firms. In 2011 Danny opted to start her own practice, which has since grown into a successful boutique employment law firm with Danny and her firm receiving 7 Doyles Guide recommendations since 2015. In addition to her busy practice, Danny teaches employment law at UNSW, is a long standing member of the Law Society Employment Law Committee and volunteers on Fair Work Commission pro-bono schemes.

Michael Doherty

Principal, Michael Doherty Legal, Sydney

Michael Doherty was admitted to practice in 2002. Michael gained an impressive reputation at a top-tier national firm, appearing in some of the most significant industrial cases in the past 10 years. In 2016, he started his own employment and industrial relations firm, receiving two recommendations from Doyles Guide in that year. He is a member of the Employment Law Sub-Committee of the Law Society of NSW and the Industrial Relations Society of NSW.

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Legislation

Restraints of Trade Act 1976 (NSW)