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RESTRAINT OR RESTRICTION OF TRADE

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Restraint or restriction of trade?

Where all parties intended to create a valid lawful restraint agreement, it is lamentable that due to poor draftsmanship the ex-employer loses all protection, possibly to the point of ruin. **BY ROBERT DEAN**

SNAPSHOT

- This article looks at the difficulty the courts have in dealing with restraint of trade clauses in Australia (*Maggbury Pty Ltd v Hafele* [2001] HCA 70, at [95]).
- It compares the strict approach the courts exercise in construing such clauses in Victoria in comparison to other states, for example *IF Asia Pacific Pty Ltd v Galbally* [2003] VSC 192 and *Rentokil v Lee* (1995) 66 SASR 301, at [319]-[320].
- It offers tips for drafting restraint of trade clauses in Victoria to avoid legal traps.

When it comes to restraint clauses, a Victorian practitioner could be forgiven for believing that the modern and sensible interpretation of commercial contracts has been overridden by the burden of proof on the employer. Showing reasonableness is a minefield – one step too far and all is lost.

It is submitted that this is not the view of the High Court, or that prevailing in NSW or South Australia.

The present state of affairs was lamented by Callaghan J in *Maggbury Pty Ltd v Hafele Australia Pty Ltd* (*Maggbury*),[1] a case concerning restraint of trade: "There is a further difficulty. The doctrine of restraint of trade, as I earlier suggested, has not been clear in its application. A doctrine that provides no clear criteria for the ascertainment of the situations to which it applies can only be regarded with deep concern".

In *Maggbury* Gleeson CJ, Gummow and Hayne JJ said at [11] (referring to a judgment of Lord Hoffmann) that the interpretation of such an agreement involves "the ascertainment of the meaning which the document would convey to a reasonable person having all of the background knowledge which would reasonably have been available to the parties in a situation in which they were at the time of the contract".

Gleeson J noted at [43] that a detailed semantic and syntactical analysis of a commercial contract must give way to business common-sense and that one may even ask has something gone wrong with the language? Kirby J in the same case said at [71]: "The restraint of trade doctrine, being an invention of the common law, must be applied to the facts with a broad and flexible rule of reason".

It is perplexing that, particularly in Victoria, a different approach is taken. The difference is between assuming that the parties intended to enter into a valid agreement and an assumption that an employer, possibly deliberately, intends to unfairly reduce competition with the result that he or she ends up with no protection at all.

South Australia

In *Rentokil Pty Ltd v Lee* (*Rentokil*)[2] there was a prohibition on the ex-employee engaging in "any capacity" in the stream of business (of which the employer had a number). The Court read down the restraint to mean the stream in which the employee had been engaged and "capacity" to be the capacity in which he or she had been engaged (as a hairdresser). Matheson J said (319), citing *Hayes v Domain*:[3]

"Agreements in restraint of trade, like other agreements, must be construed with reference to the object sought to be obtained by them. In such cases as the one before us, the object is the protection of one of the parties against rivalry in trade. Such agreements cannot be properly held to apply to cases which, although covered by the words of the agreement, cannot be reasonably supposed ever to have been contemplated by the parties, and which on a rational view of the agreement are excluded from its operation by falling, in truth, outside, and not within, its real scope".

His Honour continued at (319 – 320): "The last words used by Lord Macclesfield in giving judgement in *Mitchell v Reynolds*[4] were; '. . . if . . . it appears to be a just and honest contract it ought to be maintained . . . The court ought not to hold a just and honest agreement void, even when to enforce it would be just, simply because the agreement is so unskillfully worded as apparently, or even really, to cover some conceivable case not within the mischief sought to be guarded against. Public policy does not require so serious a consequence to be attached to the want of accuracy in expression. To hold such an agreement wholly illegal and void is to lose all sense of proportion, and is not necessary for the protection either of the defendant or of the public".

In the same case Debelle J said at (337): "It is reasonable for an employer to seek to cover all likely events. Human ingenuity will readily find a means of avoiding a provision which describes too

precisely the position of the former employee . . . It is not unreasonable, therefore, for an employer to draw a covenant in restraint of trade in terms which are wide enough to include activities which on their face appear to go beyond the kind of activity in which the employee had been engaged . . .

". . . But the courts should not frame rules that have a consequence that it is almost impossible to draft a covenant which at the same time is wide enough to bind a former employee in a fair and reasonable manner and is not unenforceable because of the width with which it is expressed . . ."

In another South Australian case *Avellino v All Australian Netball Association Ltd*[5] Bleby J noted at [102] a suitable warning by Gummow J in *Adamson v NSW Rugby League Ltd*:[6]

"In deciding whether there are special circumstances justifying a restraint of trade, the court should be wary of placing weight upon improbable and extravagant contingencies as indicating the restraint to be unreasonable. See *Haynes V Doman* [1899] to Ch 13 at 26".

Importantly, without shifting the burden of proof (that the restraint clause is reasonable) from the shoulders of the employer, these courts will nevertheless begin from the position that the parties intended to agree to a valid restraint of trade clause and only then see if the clause is undeniably too wide to read down to meet the parties expectations.

New South Wales

In NSW the courts also take a flexible, robust approach to restraint of trade clauses.

The operation of the *Restraints of Trade Act 1976* (NSW) ss4(1) and 4(3) have much the same effect as the requirements set out in *Rentokil*. In *Cactus Imaging Pty Ltd v Glen Peters*[7] the operation of that Act is set out ". . . the effect of the *Restraints of Trade Act* s4(1), is to require that, for the purpose of determining the validity of a restraint attention to be focused on the actual or apprehended breach rather than on imaginary or potential breaches".

Evidence of the approach is found in a leading NSW case *Koops Martin v Dean Reeves*.[8] Brereton J at [55] breaks further ground in holding that the extent of business left open to the ex-employee is a relevant consideration. He refers to *Stenhouse Australia Ltd v Phillips*,[9] *Guildford Motor Company v Home*,[10] *Bridge v Davies*[11] *and Business Seating Renovations v Brood*.[12]

In *Portal Software International Pty Ltd v Bodsworth*[13] White J said with respect to the relevant clause that if read literally it would extend to contacting clients for purposes unrelated to work for the previous employer. However, his Honour said:

"The clause must be construed according to its object of preventing the employer's business being damaged by the activities of the employee after the

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TIPS

The following tips may be useful to the practitioner. Each in itself is worthy of extensive discourse but can be summarised as:

- Do not use a restraint clause from one agreement in another;
- If the employment changes, so must the restraint clause;
- Determine the interest to be protected first and use time area and business activity to obtain protection;
- The extent of that protection must be no more than the interest or it will be deemed to be an unreasonable restraint resulting in no protection – less is more;
- The time allowed is only that which would allow the new employee to "catch up" and establish a relationship with the ex-employees clients;
- The identity of the clients should be limited to only those clients of the ex-employee;
- Business activity is only equivalent to the business the ex-employee was carrying out and should steer clear of related corporations.
- Be ready to argue these matters of law and fact strenuously at the interlocutory stage.
- Avoid restrictions on poaching ex-employees – that area has become quite complicated.

Ladder clauses are acceptable, but too many could lead to invalidity (3 x 3 x 3 will be acceptable).[24] It may be the time to re-examine general condition 12 of the REIV LIV Copyright Sale of Business Agreement.

termination of his employment. As in *Butt v Long* and *Home Counties Dairies Ltd v Skilton*, the kinds of dealings which are prohibited are to be determined by reference to the nature of the business conducted by the employer which the clause was designed to protect".

United Kingdom

UK courts have long taken the view that they will look at broad restraints according to what was reasonably in the contemplation of parties according to an ordinary sensible person (*SBJ Stephenson Pty Ltd v Mandy*).[14] The courts will ignore improbable or unlikely events and they will not look at hypothetical events, and to be taken into account those events must at least be a probable contingency at the time the covenant was made (*Commercial Plastics v Vincent*).[15]

Victoria

In *IF Asia Pacific Pty Ltd v Galbally (IF Asia)*[16] the restraint term was that "upon termination, you [the ex-employee] shall not for the period of one year be employed by any person which is a client at the date of termination of your employment". Clause 2 was a non-solicitation term.

Dodds-Streeton J held that to read down the solicitation clause to mean the same or similar business to that in which the ex-employees had been engaged was impermissible. One must ask why the parties, intent on a legal valid agreement, would not have meant services to be restrained to be limited to those in which the ex-employee had been engaged?

The Court relied on *Butt v Long*. Interestingly enough, in that particular case the High Court read down the general word transhipping to mean transhipping by road.[17]

Her Honour referred to *Mills v Dunham*[18] in which the term non-solicitation was read down to mean non-solicitation of "a business similar to that of the plaintiff". Her Honour distinguished *Mills v Durham* by noting that the nature of the plaintiff's business was expressly set out in another clause of the agreement.

The judge noted a similar situation in *Business Seating (Renovations) Ltd v Broad*[19] *and G W Plowman and Sons Ltd v Ash*[20] where the contracts themselves describe the type of services the company actually performed and accordingly the restraint could be read down to that effect. One must wonder whether the reference to the business in the contracts was good management or good luck. Other draftsmen are not so lucky.

Her Honour said: "Subject matter, contents of the documents, and such evident evidence as there is of surrounding circumstances do not, in my opinion, cause an inference to arise with 'such force as to carry conviction to the mind' that the parties intended the restriction thus justifying its implication into perfectly general words".

Rather than assuming the parties intended the contract to be lawful and binding, Her Honour was waiting to be shown with conviction that this was the case. It is hard to understand that such a simple concept as "what did you do as an employee" cannot be transposed to mean "that is the business we mean not to engage in".

For Her Honour the solicitation and the business service in the restraint had to match exactly the work the ex-employee did for the employer. But this is unlikely to happen especially when, as Debelle J pointed out above, the employer is understandably trying to ensure his or her business is fully protected.

In Victoria it has become a matter of the drafting skill of a practitioner pitted against the somewhat sceptical and intense scrutiny of the court.

Much the same problem has surrounded Victoria's dealing with the phrase "related companies" in restraint clauses. What is arguably no more than a very bad habit of copying that term into restraint clauses has caused many a proprietor to fall on their swords. In Victoria such a term is lethal and invites ruin. The attitude taken by the courts is that by including related companies in non-solicitation clauses where those companies undertake services not associated with the services in which the employee was engaged, is an attempt by the employer to stifle competition. The truth is probably not so sinister. It is simply bad draftsmanship.

In *IF Asia*, Dodds-Streeton J held she could not sever the "related companies" because she could not be sure of their business. Hence the restraint fell.

In *Courtenay, Polymers Pty Ltd v Deang*[21] the defendant was prohibited

from carrying on business likely to be in competition with the employer or any related companies. Whelan J held that there was no evidence adduced as to the nature of or number of the related companies. The businesses of Courtney Polymer related companies were unclear. His Honour refused to sever those terms. The restraint clause was held invalid.

In *Transpacific Industries v Whelan*[22] a similar clause was held to be unreasonable. There was evidence as to the business of the related corporations which was quite different to the businesses undertaken by the employee but "related corporations" were not severed, rather the restraint was held invalid.

The Court knew what services the defendant had supplied. His Honour said: ". . . It is certainly the case that Mr Whelan was specifically concerned with landfill . . . the problem arises precisely because the ambit of the employees' activities is demonstrably narrower than the ambit of the restraint".

It was clear what the ex-employee's services were and that it is arguable that neither the ex-employee nor the ex-employer thought the ex-employee should be prevented from engaging in all those unrelated services of the subsidiary companies, services he had never performed. But a draftsperson had put in "related companies" so the ex-employer had no protection at all.

The Victorian courts continue to take a conservative approach as shown in *Wallis Nominees (Computing) Pty Ltd*.[23]

Conclusion

It is difficult for a proprietor to understand that, when both he and the ex-employee strike a bargain which is fair and which they both understand and accept, a forensic approach to the drafting of that bargain by a court appears to unjustly leave him or her without protection and his ex-employee free to acquire his or her business. ■

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1. [2001] HCA 70, at [95].
2. (1995) 66 SASR 301, at pp319-320.
3. [1899] 2 Ch 13, 24 to 26.
4. 1711 1 P Wms 181, 197; 24 ER 347, 352.
5. (2004) 87 SASR 504; [2004] SASC 56.
6. (1991) 31 FCR 242, at 286.
7. [2006] NSWSC 717, at [10].
8. [2006] NSWSC 449.
9. [1974] AC 391.
10. [1933] 1 Ch 935.
11. [1984] 1 AC 705.
12. [1989] ICR 729 733.
13. [2005] NSWSC 631, at [33].
14. [2000] FSR 286, 287.
15. [1964] 3 All ER 546, 643.
16. [2003] VSC 192.
17. The High Court refused to impose a geographical limitation because geographical limitation is something which can only be fixed by the parties.
18. [1891] 1 Ch 576.
19. [1989] 1 CLR 729.
20. [1964] 1 WLR.
21. [2005] VSC 318.
22. [2008] VSC 403 (nb: the author was engaged in this case).
23. [2013] VSCA 24.
24. However, in the recent case of *Bulk Frozen Foods Pty Ltd v Excell* [2014] TASSC 58, 8019 combinations were allowed because it was a "genuine attempt to define . . . the need for protection".