Protecting employers' goodwill from attack: restrictive covenants, confidential information and the fiduciary obligations of former employees

Restrictive Covenants: Restraint of Trade

The Doctrine of Restraint of Trade

1 At common law, a restraint of trade is contrary to public policy and void unless it can be shown that the restraint is, in the particular circumstances of the case, a reasonable one.[1] The onus is on the employer to justify the restraint placed upon the employee by the covenant.[2]

2 The rationale for the doctrine against restraint of trade is that "*every man shall be at liberty to work for himself, and shall not be at liberty to deprive himself or the state of his labour, skill, or talent, by any contract that he enters into*".[3]

3 It is sufficient justification that the restraint be reasonable having regard to the interests of the parties concerned and the public interest. However, the restraint must afford no more than adequate protection for the plaintiff's interest.[4] Any restraint that goes beyond what the Court considers to be reasonable protection must be struck down.[5]

4 The validity of the restraint is tested at the time of entering into the contract and by reference to what the restraint entitled or required the parties to do rather than what they intend to do or have actually done.[6] Therefore, in order to assess the reasonableness of the restraint clause in this case, it is necessary to determine how it was to operate.

5 Where a contractual provision is impeached on the basis that it unreasonably restrains trade, the duty of the Court is first to interpret the provision itself, and to ascertain according to the ordinary rules of construction the fair meaning of the parties, before considering whether it is a valid restraint.[7] The ordinary principles of construction are to apply.[8] The question is what a reasonable person in the position of the parties at the time it was entered into, with knowledge of the surrounding circumstances and the object of the transaction, would understand it to mean.[9]

The employer must have a legitimate business interest to enforce the restraint

6 The employer can only enforce the restraint against the defendant if it can establish that the restraint provides reasonable protection for a recognised legitimate business interest.

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[1] *Nordenfelt v Maxim Nordenfelt Guns & Ammunition* [1894] AC 535 at 565
[2] *Herbert Morris Ltd v Saxelby* [1916] 1 AC 688 at 715
[3] *Herbert Morris Ltd v Saxelby* [1916] 1 AC 688, 701.
[4] *Maxim Nordenfelt Guns & Ammunition* [1894] AC 535, 565; *Herbert Morris* above n2, 706.
[5] *Maggbury Pty Ltd v Hafele Australia* Pty Ltd [2001] HCA 70, 176.
[6] *Woolworths Ltd v Olson* [2004] NSWCA 372 [40].
[7] *Mills v Dunham* [1891] 1 Ch 576 at 579 per Chitty J.
[8] *Butt v Long* (1953) 88 CLR 476
[9] *Toll v Alphapharm* (2004) 219 CLR 165

7 The question of whether the employer had one or more legitimate business interests to justify the restraint is assessed with regard to the circumstances that applied at the time the employer and the employee entered into the employment contract containing the restraint clause.[10] It is not to be determined on the basis of the employee's actual experience during their employment or at the time of his resignation.[11]

8 Mere protection of one's business against ordinary competition, *per se,* is not a legitimate interest warranting protection by a restraint covenant.[12]

9 The particular skills or experience that the employee may have gained in the course of his employment with the employer also do not constitute a legitimate business interest that the employer is entitled to protect by way of restraint.[13] An employer cannot enforce the restraint to prevent an employee from using the human capital he/she acquired while employed by the employer to pursue a career elsewhere.

10 Three specific interests have been recognised at common law as being legitimate business interests protectable by appropriate restraint covenants: customer connection, staff stability and "opportunistic disintermediation".

Customer connection

11 'Customer connection' is an accepted legitimate interest that may reasonably be protected by restraint. It is an employer's interest in maintaining its connection and goodwill with its customers against misappropriation by its employees or contractors.[14] If the employer encouraged or expected the employee to acquire a special knowledge of or influence over its clients in the course of providing services to those clients, then it might be able to restrain the defendant from exploiting that customer connection for a reasonable period post-employment.[15]

12 In *Informax*[16], Perram J observed that '*the mischief which the [customer connexion] principle is designed to address…is the fact that there are employees whose position is such that they have the practical ability to control the business of their employer's customer as if those customers were their own. It is against that risk that this doctrine is pitched and the various tests articulated in this area are all necessarily hewn to the end of identifying that risk in the case of particular employees'*.[17]

13 The question of whether a protectable customer connection interest exists will depend, according to the Victorian Court of Appeal in *Wallis Nominees v Pickett*[18], on whether the nature of the employee's employment and relationship with customers gave rise to a risk that the employee could control the

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[10] *Wallis Nominees (Computing) Pty Ltd v Pickett* [2013] VSCA 24 ("*Wallis Nominees")* at [34] per Warren CJ and Davies AJA
[11] *Koops Martin v Dean Reeves* [2006] NSWSC 449 [53] ("*Koops")*.
[12] *IF Asia Pacific Pty Ltd v Galbally* [2003] VSC 192 at [102].
[13] *Kerchiss v Colora Printing Inks Ltd RPC* [1960] 9 RPC 235, 239; *Linder v Murdock's Garage* (1950) 83 CLR 628, 646.
[14] *Informax International v Clarius* Group (2011) 192 FCR 210 ("*Informax*") at 219, citing *Lindner v Murdock's Garage* (1950) 83 CLR 628 at 633-634 per Latham J
[15] *Koops*, above n5 [66].
[16] n 14 above
[17] *Informax*, at [29]
[18] *Wallis Nominees* at [32]

customer's business or to become the 'human face' of the employer's business, even if that was not intentional.

Stable workforce

14 Courts have recognised that an employer may have interests in the arrangement of its staff as a whole. In *Cactus Imaging Pty Ltd v Peters*[19] Brereton J concluded a connection between staff and a business is a legitimate interest that can be protected by a restraint against poaching staff.[20] Similarly in *Aussie Home Loans v X Services*[21], White J recognised an interest in maintaining a stable workforce to justify restraining an ex-employee from using confidential information about the identity and roles of employees to poach those employees.[22]

15 *Cactus* concerned a situation in which a former manager was seeking to use his influence and connection over the staff he previously managed to recruit or poach them for a new business. Brereton J held that the connection or influence acquired by the manager was intertwined with the goodwill of his former employer's business and something which that employer could protect through a reasonable restraint.[23]

Opportunistic disintermediation

16 The Federal Court decision *Informax*[24] developed the principles enunciated in *Cactus* and followed United States authorities to recognise the legitimate interest of a labour hire firm in avoiding the risk of "opportunistic disintermediation." This is the unfair elimination of the covenantee's "middleman" role as an intermediary in the market for information between "job shoppers" and clients. A labour hire firm was found to have a legitimate interest in protecting itself against the perils of opportunistic disintermediation – that is, the risk of being cut out of the deal between a job-seeker and a client by virtue of the client dealing directly with the job-seeker. The interest involved is "an interest in recouping expenditure together perhaps with a profit component, or, to put it slightly differently, it is an interest in being permitted profitably for the introduction of the contractor to the client".[25]

17 However, Perram J in *Informax* ruled that in order to rely on the anti-opportunistic disintermediation interest, the covenantee must lead evidence of the value of the investment it has made into arranging the placement of contractors with its clients[26]; that is, the value of the resources expended in recruiting, training and matching up the skills and experience of consultants with the needs of particular clients.

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[19] [2006] NSWSC 717.
[20] *Ibid* [45].
[21] [2005] NSWSC 285; (2005) ATPR 42-060.
[22] *Ibid* [22].
[23] *Cactus*, above n9 [55].
[24] *Informax,* n 14 above
[25] *Informax* at [58]
[26] *Informax* at [65]

To be enforceable, the restraint covenant must do no more than is reasonably necessary to protect the legitimate interest.

18 As already stated, the restraint must afford no more than adequate protection for the plaintiff's interest.[27] Any restraint that goes beyond what the Court considers to be reasonable protection must be struck down.[28] The reasonableness of the restraint clause is assessed having regard to the activity purportedly proscribed and the period of its operation. The test is whether the restraint offers reasonable protection for the legitimate interest that the employer claims, without going beyond what is reasonable. This test is applied against the circumstances that applied immediately before the defendant signed his employment contract.[29]

19 Where some interest in the customer connection between the employer and its customers is sought to be protected, then a measure of the reasonableness of the restraint is to ask how long it would take a reasonably competent replacement employee to establish a rapport with the client, displacing the former employee's influence with the client, or to ask how long the employee's hold over the client is expected to last before weakening.[30]

20 A covenant that restrains the employee from carrying on the employer's business (for example, "tailoring"), but which extends further than the job in which the employee was in fact engaged ("tailoring, haberdashery, upholstering, bootmaking or like services", for example), will likely be regarded as too wide.[31]

21 Where the anti-opportunistic intermediation interest is relied upon, the reasonableness of the restraint is assessed according to the time that the covenantor reasonably needs to recoup its investment. As Perram J noted in *Informax:* "*Unlike the interest in customer connexion which may be thought, in many cases, to be one which grows more substantial the longer the employee works with the client, the interest in avoiding the loss of the ability to recoup a business expense is likely to diminish as time passes and less and less remains to be recouped*".[32]

22 The value of a disintermediation interest is ordinarily calculable by reference to the expenses incurred and the fair profit that the 'middleman' might expect to earn from the endeavour. Payment of a flat fee or damages would readily remedy the loss of that interest. In that sense, damages are likely to be an adequate remedy; an injunction or restraint may not be warranted.

23 The geographic area and time duration of the restraint must also be reasonable, having regard to the interest being protected. Area and time are usually bundled together; the more area the restraint covers, the less time would be considered reasonable. The more clients in a field that an employee is prevented from working with, the less time would be considered reasonable.[33]

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[27] *Maxim Nordenfelt Guns & Ammunition* [1894] AC 535, 565; Herbert Morris above n2, 706.
[28] *Maggbury Pty Ltd v Hafele Australia Pty Ltd* [2001] HCA 70, 176.
[29] *Koops*, above n5 [53].
[30] *Wallis Nominees v Pickett* at [56] per Warren CJ and Davies AJA
[31] *Koops* at [73], citing *Morris & Co v Ryle* (1910) 103 LT 545; *Attwood v Lamont; Morse v Fowler* (1899) 44 Sol Jo 89; also Heydon 'Restraint of Trade' p 150.
[32] *Informax* at [63]
[33] *Wallis Nominees v Pickett* at [60] per Warren CJ and Davies AJA

24 In *Birdanco Nominees Pty Ltd v Money*[34], a restraint clause prohibiting an accountant from providing accounting services to a former client for a period of three years was held to be a reasonable restraint, having regard to the employer's interest in protecting customer connection.[35] In reaching that conclusion, the Court noted that the restraint did not prevent the accountant from trading in competition with the former employer or providing accounting services generally, and in fact permitted the former employee to provide services to a former client if liquidated damages were paid.

25 Conversely in *Wallis Nominees v Pickett*, a restraint prohibiting a former IT consultant from providing services to a former client for 12 months was found by the majority of the Court of Appeal to be unreasonably long.[36]

Validity of the restraint provision cannot always be achieved by severance, or by reliance on only part of the provision.

26 The courts have recognised a strictly circumscribed role for severance in the context of employee restraint covenants.[37]

27 In *Arnotts Limited v Bourke*[38], Young J refused to save an unjustifiably wide restraint clause by severing subordinate provisions on which the employer did not rely, because doing so would effectively create a new covenant.

28 In *Business Seating Renovations Ltd v Broad*[39], Millet J permitted the severance of a reference in the restraint to 'clients of related companies of the employer', saying that 'a contract can be severed if the severed parts are independent of one another and can be severed without the severance affecting the meaning of the part remaining.' Her Honour Dodds Streeton J, however, cautioned courts against active disentanglement of unreasonably wide clauses, recognising that in doing so a court may act *in terrorem* by exposing employees to the threat of litigation: "*Undue judicial readiness to save such clauses by severance reduces the sanction of invalidity otherwise applicable to employers who attempt to impose unjustifiably wide restraints*".[40]

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[34] [2012] VSCA 64
[35] *Ibid* at [84]
[36] at [65].
[37] *Attwood v Lamont* [1920] All ER 55 at 65
[38] Matter No. 1599/99 [1998] NSWSC 170 (14 May 1998), cited in *IF Asia Pacific Pty Ltd* at n 12 above at [193]
[39] [1989] ICR 729
[40] *IF Asia Pacific* n 12 above at [201].