DRAFTING AND ENFORCING RESTRAINTS OF TRADE

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1. INTRODUCTION

1.1 The purpose of this paper is to provide a practical guide to drafting and enforcing restraints. However, we appreciate that a number of the people reading this paper are looking for something that they can copy and paste into submissions. For those of you who fall into this category, please see sections 2 and 3 below.

1.2 For the remainder of you, rather than delving into case law and analysing the various inconsistent Court decisions that exist in this area of law, we have attempted to set out a basic guide as to what you should consider when drafting restraint of trade clauses and what you should prepare if you are seeking to enforce a restraint of trade clause.

2. RELEVANT LEGAL PRINCIPLES – RESTRAINTS OF TRADE GENERALLY

2.1 The principles relevant to the validity of restraint of trade clauses are now well settled. 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 circumstances of the particular case, reasonable.[1]

2.2 The onus at common law of showing that the restraint goes no further than is reasonably necessary to protect the interests of the person in whose favour the restraint operates lies on the party seeking to support the restraint as reasonable.[2]

2.3 The validity and reasonableness of the restraint is to be determined as at the time it is entered.[3]

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[1] *Nordenfelt v Maxim Nordenfelt Guns and Ammunition Co Ltd* [1894] AC 535 at 565; *Amoco Australia Pty Ltd v Rocca Bros Motor Engineering Co Pty Ltd* (1973) 133 CLR 288 at 315.
[2] *Adamson v New South Wales Rugby League Limited* (1981) 27 FCR 535 at 554 per Hill J
[3] *Portal Software v Bodsworth* [2005] NSWSC 1179 per Brereton J at [83], citing, inter alia, *Nordenfelt v Maxim Nordenfelt Guns and Ammunition Co Ltd* [1894] AC 535 at 574, *Lindner v Murdock's Garage* (1950) 83 CLR 628, *Adamson v New South Wales Rugby League Limited* (1991) 31 FCR 242 at 285 per Gummow J, *Woolworths Limited v Olson* [2004] NSWCA 372 at [40], and *Curro v Beyond Productions Pty Ltd* (1993) 30 NSWLR 337 at 344.

2.4 When exercising its discretion to grant and fashion relief, the Court considers matters as at the date of hearing[4] including matters pertaining to the conduct of the defendant.

2.5 In New South Wales, it is not strictly correct that a restraint is prima facie void; a restraint is valid to the extent to which it is not against public policy, even if not in severable terms: *Restraints of Trade Act 1976* (NSW) (**Restraints of Trade Act**), section 4(1).[5] The effect of the Restraints of Trade Act is to allow the restraint to be read down so as to be valid to the extent necessary only to capture the conduct of the offending party, if a restraint to that extent would have been valid.[6] Consequently, in New South Wales, one approaches the case by determining:

a) Firstly, whether the alleged breach (independently of public policy considerations) does or will infringe the terms of the restraint properly construed;

b) Secondly, whether the restraint in its application to that breach is against public policy; and

c) Thirdly, if it is not, then in its application to the alleged infringing conduct, the restraint is valid unless the court makes an order under s.4(3) of the *Restraints of Trade Act*.[7]

2.6 It is recognised that although the legal principles applicable to determining whether a restraint is reasonable are the same when a sale of business agreement and an employment contract (in which the employee did not receive a capital payment) there may be different matters of emphasis for the court when construing a sale of business agreement. As stated in *BDO-Group Investments (NSW-Vic) Pty Ltd v Ngo* [2010] VSC 206 at [40]:

> In the context of the sale of a business, the approach of the courts is, essentially, based on commercial fairness and the need to hold parties to the bargain which they made. Consequently, a court will be reluctant to hold a restraint unreasonable if that would enable the vendor to obtain the purchase price without providing the whole of the consideration bargained for by the

[4] *Otis Elevator Company Pty Limited v John Nolan* [2007] NSWSC 593 at [17]- [30]; and *John Fairfax Publications Pty Ltd v Birt* [2006] NSWSC 995 at [45]- [46].
[5] See *Orton v Melman* (1981) 1 NSWLR 583; *Koops Martin v Reeves* [2006] NSWSC 449 at [27] per Brereton J
[6] *Orton v Melman* (1981) 1 NSWLR 583
[7] *Orton v Melman* [1981] 1 NSWLR 583; *Woolworths Ltd v Olson* [2004] NSWCA 372 at [42]

purchaser. It is also clear from the cases that it is also relevant, when considering whether a restraint is reasonable, to have regard to the relative bargaining positions of the parties to the contract. *In Esso Petroleum Co ltd v Harper's Garage (Stourport) Ltd*, it was said that when 'free and competent parties agree, and the background provides some commercial justification on both sides for their bargain' the onus of establishing the reasonableness of the restraint should be easily discharged.

3. RELEVANT LEGAL PRINCIPLES – CONFIDENTIAL INFORMATION AND CUSTOMER CONNECTION

3.1 The usual asserted grounds of protectable interests are trade secrets, confidential information and goodwill (which includes but is not limited to customer connections).[8] However, the categories are not closed.[9] An employer is entitled to protection of its goodwill including but not limited to customer connections.[10]

3.2 In *Zomojo Pty Ltd v Hurd (No 2)* [2012] FCA 1458 at [179], her Honour Gordon J stated that the relevant principles to be applied in determining the validity of a clause restricting the use of confidential information are as follows:

a) an obligation can be imposed by contract to keep information confidential and that obligation can extend to cover subject matter which is not protected by an equitable duty of confidence: *Wright v Gasweld Pty Ltd* (1991) 22 NSWLR 317 at 329, 335 and 340-341; *Del Casale v Artedomus (Aust) Pty Ltd* [2007] NSWCA 172; (2007) 73 IPR 326 at [34]- [36], [38], [46], [48], [50], [51], [77], [87], [92], [102], [118], [134] and [140] and *Reed Business Information Pty Ltd v Seymour* [2010] NSWSC 790 at [36];

b) employers are entitled to protect by contractual covenant the use of information that is the result of work, experimentation and expense: *Exchange Telegraph Company Limited v Central News Limited* [1897] 2 Ch 48 at 53-54; *AB Consolidated Ltd v Europe Strength Food Co Pty Ltd* [1978] 2 NZLR 515; *Interfirm Comparison (Aust) Pty Ltd v Law Society of New South Wales* [1975] 2 NSWLR 104 at 117; *Industrial Furnaces Ltd v Reaves* [1970] RPC 605 at 617 and *International Scientific Communications Inc v Pattison* [1979] FSR 429 at 434;

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[8] See *Cactus Imaging Pty Ltd v Peters* (2006) 71 NSWLR 9 at [11].
[9] Heydon JD, *The Restraint of Trade Doctrine*, 3rd Ed (2008) Sydney, p133.
[10] *Koops Martin v Dean Reeves* [2006] NSWSC 449 at [29].

c) the know-how, or knowledge of how to solve particular problems or the knowledge of methods not necessarily shared by others, acquired by an employee during his or her employment, while ordinarily not protected by equity, is capable of being protected by a contractual covenant: *Printers & Finishers Ltd v Holloway (No 2)* [1964] 3 All ER 731 and 735-736*; Wright at 329; Commercial Plastics Ltd v Vincent* [1965] 1 QB 623 at 642 and *Milwell Holdings Ltd v Johnson* [1988] NZHC 199; (1988) 12 IPR 378 at 391-3;

d) a contractual restraint upon the use of confidential information or know-how may be enforceable provided it is reasonable, in the sense of being necessary for the adequate protection of the interests of a party: *Brightman v Lamson Paragon Ltd* (1914) 18 CLR 331 at 335 and *Reed Business Information* at [36];

e) whether a restraint is reasonable is a question of law and not of fact: *Attorney-General (Cth) v Adelaide Steamship Co Ltd* [1913] UKPCHCA 2; (1913) 18 CLR 30 at 35; Buckley v Tutty [1971] HCA 71; (1971) 125 CLR 353 at 377; A*moco Australia Pty Ltd v Rocca Bros Motor Engineering Co Pty Ltd* [1973] HCA 40; (1973) 133 CLR 288 at 317-318; *Drake Personnel Ltd v Beddison* [1979] VicRp 3; [1979] VR 13 at 19 and *Cream v Bushcolt Pty Ltd* [2004] WASCA 82; (2004) ATPR 42-004 at [23] and [30];

f) in determining whether a restraint is reasonable the court should consider what is necessary to protect the legitimate interests of the person asserting the restraint in the circumstances of the case, assessed from the date of making the contract and making the best possible estimate of probabilities and contingencies then foreseeable: *Amoco* at 318; *Drake Personnel* at 25; *Woolworths Ltd v Olson* [2004] NSWCA 372 at [40] and *Reed Business Information* at [36]; and

g) where, as here, the restraint concerns confidential information, the circumstances to be considered by the Court include:

   i) the extent to which the information is known outside the business;

   ii) the skill and effort expired to collect the information;

   iii) the extent to which the information is treated as confidential by the employer;

   iv) the value of the information to competitors;

v) the ease or difficulty with which the information can be duplicated by others;

vi) whether it was made known to the employee that the information was confidential; and

vii) whether the usages and practices in the industry support the claim of confidentiality,

Reed Business Information at [36].

3.3 Insofar as customer connections are concerned, it is well settled that an employer's customer connection is an interest which can support a reasonable restraint of trade.[11]

3.4 In *Cactus Imaging Pty Ltd v Peters* [2006] NSWSC 717; (2006) 71 NSWLR 9 at [25] Brereton J explained an employer's legitimate interest in the protection of its customer connections. His Honour said:

> It is plain that an employer's customer connection is an interest which can support a reasonable restraint of trade: *Hitchcock v Coker* [1837] EngR 482; (1837) 6 Ad & El 438 at 454, [1835–42] All ER Rep 452 at 456–457 (Tindal CJ); *Herbert Morris Ltd v Saxelby* (at 709); *Dewes v Fitch* [1920] 2 Ch 159 at 181; *Coote v Sproule* (1929) 29 SR (NSW) 578 at 580, 46 WN (NSW) 180 at 181 (Harvey CJ in Eq); *Lindner v Murdock's Garage* (at 633–634) (Latham CJ, Webb J agreeing), (at 650) (Fullagar J), (at 654) (Kitto J); and *Koops Martin Financial Services Pty Ltd v Reeves* (at [29]–[33]). Such a restraint is legitimate if the employee has become, vis-à-vis the client, the "human face"of the business, namely the person who represents the business to the customer — or, as it was put by Hoover J in *Arthur Murray Dance Studios of Cleveland Inc v Witter* (1952) 105 NE (2d) 685 at 706 (Ohio): "The personal relation between the employee and the customer [is] such as to enable the employee to control the customer's business." (And see *Twenty-First Australia Inc v Shade* (Young J, 31 July 1998, unreported) at 12; K*oops Martin Financial Services Pty Ltd v Reeves* (at [34]).) While the employer is not entitled to be protected against mere competition by a former employee, the employer is entitled to be protected against unfair competition based on

[11] *Cactus Imaging Pty Ltd v Peters* (2006) 71 NSWLR 9 at [25]

> the use by the employee after termination of employment of the customer connection which the employee has built up during the employment — which, because the employee has in effect represented the employer from the customer's perspective during the employment, might at least temporarily appear attached to the employee, but in truth belongs to the employer: *Koops Martin Financial Services Pty Ltd v Reeves* (at [30]).

3.5 Further, as Dickson J noted in *Elsley*, the protection afforded by the non-solicitation and confidentiality provisions is unlikely to be perfect given the difficulties of proof of breach. In *Lindner v Murdock's Garage* [1950] HCA 48; (1950) 83 CLR 628, Latham CJ also observed at 636-7 that an employer's interest in customer connections may not be sufficiently protected by a covenant against solicitation and that a covenant against competition may be a more reasonable form of protection as:

> ... a covenant against solicitation ... is difficult to enforce; it is difficult to show breach and difficult to frame an injunction. The master is entitled to protect himself by a covenant against competition [637].

4. DRAFTING RESTRAINT CLAUSES

4.1 The first thing to consider when drafting a restraint clause is what is the employer's "legitimate business interest". Usually, this will be trade secrets, confidential information, or goodwill such as customer connection. It would be pointless, for example, including a non-solicitation of customers restraint for a person who will not have any contact with, exposure to or influence over customers of the employer. From an enforcement perspective, influence over customers is what will justify a restraint on solicitation and, in some circumstances, competition. Often, mere exposure will not be enough.

4.2 However, an employer should also consider (when drafting a restraint) the manner in which an employee's role may develop. For example, a junior accountant may not have much influence over customers to begin with, but it would be expected that as they progress their exposure and influence over customers will increase. In such circumstances it would be sensible to include a restraint seeking to protect the employer's customer connection.

4.3 Further, it may be likely that as an employee progresses they will have increased access to confidential information such as marketing or business plans, pricing

information and the like. In such circumstances, an employer may wish to consider including a non-competition restraint to try and prevent the employee from either deliberately or inadvertently divulging confidential information to a competitor if they were to commence employment with that competitor.

4.4 Finally, the employer should also consider including a restraint on the use and disclosure of confidential information both during and after the cessation of employment.

4.5 It is critical to consider the specific role for which the employee is engaged and negotiate a restraint specific to that role. As a matter of best practice, it is better to avoid using a boilerplate restraint. However from a practical perspective this does not seem to matter that much in New South Wales where we have the *Restraints of Trade Act*.

4.6 The matters that should be considered when drafting a restraint include:

a) the seniority of the role – the more senior the role the easier it is to justify a longer restraint;

b) the employee's access to and use of confidential information;

c) the relationship the employee will have with other employees – that is, their likely influence over other employees; and

d) the employee's contact with and influence over clients – the more influence they are likely to have over clients the easier it is to justify a longer and perhaps wider restraint depending on the client base and type of industry.

4.7 It is also helpful to include a clause that notes that the agreement is reasonable. This is not necessarily determinative but the fact that an employee voluntarily agrees to such a restraint and expressly agrees that it is no more than what is reasonable to protect the employer's legitimate interests, provides evidence in support of the reasonableness of the restraint.[12]

4.8 As matters currently stand, in New South Wales, using a cascading restraint is in fashion. This is largely the result of the decision in *Hanna v OAMPS Insurance*

[12] Russ Australia Pty Ltd v Benny [2006] NSWSC 1118 at [49]

Brokers Ltd (ACN 005 543 920) [2010] NSWCA 267 where the Court of Appeal dismissed an appeal against a decision of Hammerschlag J in which his Honour rejected arguments advanced by Hanna that a cascading restraint was void for uncertainty. At [11] to [14] in *Hanna*, his Honour Allsop P dealt with the "uncertainty" argument as follows:

> The first argument relied heavily on the existence of the definite article ("the") before each of the phrases "Restraint Period" and "Restraint Area". It ignored or failed to give adequate weight, however, to the terms and effect of cl 4. Clause 4 made clear that the various periods and areas in cl 2 were part of separate and independent provisions. Thus there were nine restraints, from the widest (15 months in Australia) to the narrowest (12 months, in Mr Hanna's case, in the metropolitan area of Sydney). All were binding. Taken as individual covenants, all capable of being understood by the use of clear words and all being capable of being complied with without breaching any of the others, the one covenant argument must fail.
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> The second argument has implicit in it a proposition that there is a legal requirement for a hierarchy of the clauses and a mechanism for their order of operation. Reduced to its essential element, there was said to be uncertainty in more than one clause covering by different terms the same ground of a party's obligation. I cannot agree with the width of these propositions. It may be that if multiple obligations on the same subject matter so conflict that a contracting party cannot know what it is to do, such clause, or the contract in which it is found, is uncertain and void. For instance, a clause that says that the party must perform by doing only act X and another clause that says that the party must perform by doing act Y (which is inconsistent with X) may lead to a conclusion of uncertainty. No such difficulty arises here. Compliance with any relevant clause will not lead to breach of any other clause. All bind, but at one level of practicality the most relevant is the widest. Nevertheless, all are binding. Neither their operation nor any principle of law concerned with certainty of contract requires a mechanism or hierarchy of order of operation.
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> This deed has nine several clauses, each clearly expressed. It may be that a complex and difficult clause with multiple permutations and combinations would be so impenetrable as to lack coherent meaning and be uncertain. That is not the case here.

14 For these reasons I do not accept the second argument.

4.9 Importantly, the clause in *Hanna* did not include any words that caused one combination of a restraint to depend on the enforceability of another wider or longer restraint. For example, we often see cascading restraint clauses that are expressed in the following terms:

a) 12 months; or if held to be unenforceable

b) 6 months, or if held to be unenforceable

c) 3 months.

4.10 In *Austra Tanks v Running*, Wootten J found that such a clause was uncertain. This is because, the content of the clause depended upon whether a court found any one or more possible elements enforceable. There were a large number of possible elements to one clause, the binding nature of which was unclear, depending as it did upon the view of a court in any proceeding. Wootten J said at 843: *"… the contract seeks to define the obligation through a series of inquiries as to what is enforceable."* There was only one covenant and there was uncertainty as to its content.

4.11 However, the Court of Appeal appears to have left the door open as to whether cascading restraints would be against public policy on the basis that clauses between employer and employee should exhibit a reasonable attempt to identify a clear and agreed reach for any post-employment constraint. That is, clauses which seek to establish a multi-layered body of restraints that are complex (even if certain) are against public policy. It will be interesting to see whether such an argument would succeed, and employers should be wary of blindly using cascading restraints when a properly considered restraint can be used.

5. ENFORCING RESTRAINTS

5.1 For the purpose of this paper, we intend to focus on how restraints are enforced in New South Wales. Although, the general approach is similar in other jurisdictions, we have decided to focus on New South Wales as it appears to be the jurisdiction in which restraint cases are most regularly heard and determined.

5.2 The first thing to remember with any breach of a restraint of trade clause is that it is URGENT. If an employer is aware of breach and has been unable to resolve the

matter quickly (within a week or two), commence proceedings. According to his Honour Young J in *Network Ten Ltd v Fullwood* (1995) 62 IR 43 at 46, letting a week go by without taking steps to enforce the restraint will require a pretty good explanation as to why any injunctive relief should be granted.

5.3 When preparing to file an injunction seeking to enforce a restraint of trade clause, it is necessary to prepare the following:

a) a Summons for Relief; and

b) affidavits in support of the Summons.

5.4 It is also sensible to prepare:

a) any notices to produce or subpoenas that will be called on at the interlocutory hearing; and

b) short minutes of order reflecting the orders for short service as set out in the Summons.

5.5 The Summons for Relief should include:

a) orders for short service in respect of the Summons, the affidavit(s), and any notices to produce and/or subpoenas;

b) the interlocutory injunctive relief that is sought; and

c) the final relief sought – this will usually include matters such as the final injunctive relief to be sought, damages and/or an account of profits, and costs.

5.6 Obviously, the affidavit (or affidavits) in support of the Summons must set out the basis on which the interlocutory injunctive relief is sought. It is sensible to draft this as carefully as possible as quite often (as set out below) the matter will proceed very quickly to final hearing and it is better to prepare the affidavit(s) as though it will be relied on at final hearing so as to avoid doubling up on costs.

5.7 The affidavit(s) should address:

a) a detailed description of what the plaintiff does (that is, the business it operates and the industry that it is in);

b) a detailed description of the nature of the employee's role;

c) matters going to the reasonableness of the restraint (refer to the relevant legal principles above) – this will certainly include their level of access to confidential information, their contact with and influence over customers, details concerning their seniority within the business, why the relevant length of the restraint is necessary, and why the geographical scope of the restraint is necessary;

d) if access and / or use of confidential information is to be relied on, it is important to set out and / or demonstrate:

(i) that the information was treated as confidential (see check-list in 3.2 above);

(ii) why it is necessary to restrain the employee from being employed by a competitor by way of a non-compete – that is, on what basis is it said that employee will be able to use the information to the plaintiff's detriment **and** may do so even inadvertently; and

(iii) the length of time the information will continue to be confidential and / or could be deployed to the plaintiff's detriment.

e) the facts leading to the termination of the relationship;

f) the facts relied on to establish breach of the restraint;

g) the risk / likelihood of harm the plaintiff faces (for which damages would not be an adequate remedy) if the injunctive relief is not granted; and

h) any steps taken by the plaintiff since discovering breach including any explanation for delay.

5.8 Once the Summons, affidavit(s) in support and any notices to produce and / or subpoenas have been prepared, the next step is to contact the Duty Judge's Associate to ascertain when the Duty Judge will hear the application for orders for short service.

5.9 In making an application for short service, the person appearing should:

a) be prepared with short minutes of order setting out the orders that are sought;

b) be able to identify with precision why the matter is urgent and what steps have been taken to enforce the restraint;

c) be able to explain any delay (if applicable); and

d) be familiar with the evidence relied on so that they can take the Judge to the evidence demonstrating breach of the restraint quickly.

5.10 Assuming the application for short service is successful, the matter will be listed for hearing of the plaintiff's interlocutory application usually within a few days of filing. At this first appearance, more often than not, the defendant will offer some form of undertaking and ask that the matter be adjourned for a short time in order for the defendant to file / serve evidence to defend the plaintiff's interlocutory application. However, it isn't uncommon for a defendant to come prepared to argue the case and, as such, any person appearing for the plaintiff should also be accordingly prepared. It is always helpful to have an outline of submissions prepared to hand up.

5.11 If the matter is adjourned, the defendant will likely serve their evidence to defend the plaintiff's interlocutory application. When acting for a defendant, there are a number of matters to consider and (where relevant) include in the defendant's affidavit:

a) firstly, consider whether there any technical arguments available concerning the construction of the restraint clause such that the defendant does not need to put on any evidence (this is a risky option as quite often a Duty Judge will simply say that the technical argument being relied on is one that should only be determined at final hearing);

b) secondly, consider the nature of the alleged breach – is there any evidence of solicitation or disclosure of confidential information or is the plaintiff seeking to enforce a non-competion restraint absent any real risk of losing customers or trade secrets;

c) thirdly, and somewhat related to the second point, why is the restraint unreasonable in its application to the defendant – that is, the affidavit should set out why the plaintiff is not at risk if the defendant commences or continues employment with their new employer;

d) fourthly, the affidavit must include details as to the prejudice the defendant will suffer if the restraint is enforced; and

e) finally, if the defendant is prepared to offer certain undertakings, ideally, the undertakings or the defendant's willingness to give undertakings should also be set out in the affidavit.

5.12 When the matter next returns to Court after a few days or a week, it will be listed for a fully contested interlocutory hearing. It is very unusual for cross-examination to take place, but it can happen. Accordingly, the person appearing (and any witnesses) should be prepared for the same.

5.13 Often the Duty Judge will stand the matter in the list and ask the parties to agree on a regime that will allow the matter to be expedited to a final hearing. Equally as often, the Duty Judge will hear and determine the interlocutory dispute which, more often than not, will effectively determine the entire matter or cause the parties to settle very quickly. If the matter proceeds to final hearing (more often than not on an expedited basis), the parties can expect a final hearing date usually within 6 or 8 weeks.

5.14 Once proceedings are commenced, whilst the parties will no doubt be incredibly busy preparing for an interlocutory and then final hearing, it is always sensible to engage in a mediation. Whilst litigation is inherently risky, trying to enforce a restraint is an even riskier proposition.

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