A–Z OF EMPLOYING

Restraints of Trade

Our guide for Employers and Managers

SUPPORTING, FACILITATING & REPRESENTING BUSINESS

BusinessCentral

Restraints of Trade

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Contents

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Overview

- Restraint of trade clauses may prohibit a former employee from competing with you in some circumstances. Restraint of trade clauses that are unreasonable may be unenforceable.
- An interim injunction is sought to enforce a restraint of trade clause; if granted, this prevents the former employee from engaging in trade or being employed by a competitor for a specified period.
- Restraints of trade are prima facie unlawful because they restrict a person's ability to participate in commerce.
- Restraint of trade clauses that are reasonable can be justified in law and upheld by the courts.
- A clause may be upheld if the employer is able to establish that it is reasonably necessary for the protection of some proprietary interest which the law recognises; provided that it is not unreasonable from the point of view of the employee and that it is not in conflict with the public interest.
- The burden of proving the reasonableness of a clause rests upon the party seeking to enforce it.

Introduction

Deterrence is a good reason for including restraint of trade clauses in your employment agreements. Sometimes this may be the only reliable reason for including such a clause in your employment agreements; most restraint of trade clauses are found to be unenforceable when tested. This A-Z guide sets out some of the legal principles applicable to restraint of trade clauses.

Refer to the **A-Z Guide** on **Confidentiality** for additional information which may assist your understanding of restraint of trade clauses.

Purpose

The idea behind a restraint of trade clause is the protection of the current employer's interests, in particular the information that the employee has had access to or used during employment with that employer. It is a restrictive or negative covenant; it is a promise to **not do** something in contrast with a promise to do something (an affirmative or positive covenant). Generally, a restraint of trade clause in an employment agreement operates to restrain the employee from being employed in similar employment, for a specified period of time, when the current employment is terminated. It is not only a restraint on trade, in this context it is also a restraint on employment.

When a restraint of trade clause applies, it is to an employment relationship which has ended. In order to hold the former employee to the clause, an injunction is required. An injunction, if granted, stops the former employee from continuing to offend against their contractual obligations and/or causing damage to the former employer.

At common law (case law), restraint of trade clauses (sometimes referred to as covenants in restraint of trade) are prima facie (on the face of it) unlawful. This is because they impose a restriction on a person's liberty, which the courts have long protected as being against public policy, wherever it occurs. In *Medic Corporation Ltd v Barrett* [1992] 3 ERNZ 523, the Employment Court explained the approach it would take with these clauses:

…I have then to bear in mind that in relation to covenants in restraint of trade there is not the same freedom of contract as exists in relation to employment contracts generally. That is because

covenants in restraint of trade, by their very nature, suppress competition and this is seen as potentially harmful to the public interest and as potentially unfair because at the time when such a provision is negotiated it is often the case that the party demanding the covenant is in a stronger bargaining position than the party on whom it is imposed. Therefore the law starts with an assumption that the covenant was unreasonable with reference to the private interests of the parties concerned and the interest of the public at large. Sometimes the part that is unreasonable can be severed from the contract without affecting the rest.

Interim Relief

Injunctions

An injunction to enforce a restraint of trade clause may be sought in the Employment Relations Authority and the Employment Court. It is usually sought on an interim basis, which means that behind the application for the injunction stands a substantive proceeding which will one day go to trial. The substantive proceeding is, more often than not, an action to recover damages that the former employer has suffered due to the former employee's breach of the employment agreement.

The decision whether or not to grant an interim injunction is discretionary; the Authority or Court does not have to grant the order sought. After reviewing the facts that are presented, the framework upon which the Authority or Court makes the decision is this:

- Is there an arguable case?
- If so, is there an adequate alternative remedy available to the plaintiffs (former employer)?
- If not, where does the balance of convenience lie?
- What is the overall justice of the case?

This framework is based on an amalgamation of case law which has long been adopted by the Employment Court and its predecessors.

Compliance orders

Theoretically, a compliance order may be sought in the Authority. Under section 137 of the Employment Relations Act 2000 the Authority has the power to order compliance where any person has not observed or complied with (among other things) any provision of an employment agreement. The section is framed in the past tense, which has been held by the Employment Court to mean that the section does not apply to prospective breaches. However, the Authority is empowered to make compliance order conditions as it sees fit, to continue in force until a specified time or the happening of a specified event. The effect of such an order, in this instance, would be to compel a former employee to comply with the restraint of trade clause; but there would have to be evidence that the former employee had breached such a clause before the application for this order could be considered.

Reasonable And Enforceable

In *Airgas Compressor Specialists v Bryant* [1998] 2 ERNZ 42, the Employment Court set out propositions of law in respect of restraint of trade clauses. These are useful in understanding what matters the Court considers when deciding whether or not a restraint of trade clause is reasonable and enforceable.

Public Interest

A covenant in restraint of trade in an employment contract is void as being contrary to the public interest and, being void, is incapable of being enforced unless one of two conditions is satisfied.

- First, a covenant in restraint of trade can be enforced if it is found to be reasonable as between the parties and with reference to the public interest.
- Secondly, such a covenant (although unreasonable) is capable of being enforced if the Court is prepared, under the Contract and Commercial Law Act 2017, to give effect to the contract of which the restraint is part after so modifying the restraint that it would have been reasonable when the contract was entered into. However, modifying and giving effect to the contract as modified is not the only option that the Court has to consider. It may also:
  - Delete the provision and give effect to the contract as so amended; or
  - Where the deletion or modification of the provision would so alter the bargain between the parties that it would be unreasonable to allow the contract to stand, decline to enforce the contract.

(See section 83 of the Contract and Commercial Law Act 2017)

In considering the public interest factor, the Court must scrutinise the restraint as at the date when the contract containing it was entered into in the light of the then prevailing circumstances. In *Walklin v Chubb NZ Ltd* [AA 191/08] it was held that a restraint of trade was unenforceable against an employee who had signed the restraint as a cadet in 1999, and had left employment as a contracts manager in 2008. The Authority held that at the time of signing, it was not necessary to have any restraining clauses on Mr Walklin as he was not responsible for and had no business or trade connections, and had no business knowledge which it would be considered necessary to protect by way of a restraint.

To be reasonable in the interests of the public, the restraint must not be injurious to the public. Reasonableness in reference to the public interest must be expressed in one or more propositions of law rather than in reference to preconceptions about or anecdotal evidence of the interests of the public at large. For example, a proposition of law which has been expressed is the right of every person to trade freely subject to reasonable restraints which are in keeping with the contemporary organisation of trade.

The party relying on a restrictive covenant must establish its reasonableness as between the parties. Once this is achieved the onus of proving that the covenant is contrary to the public interest rests on the party attacking the covenant.

Interest of the Parties

To determine whether a covenant is reasonable with reference to the interests of the parties, several questions must be asked. First, does the employer have a proprietary interest which is entitled to protection or is the covenant merely an attempt to limit or reduce competition? Secondly, is the duration, geographical ambit, and scope of the covenant too broad? Thirdly, is the covenant prohibitive of competition generally, or is it limited to proscribing the solicitation of clients of the employer? Fourthly, is the net cast wide or confined to a named competitor or reasonably compact class of competitors?

In the case of *Fuel Espresso Limited v Hsieh* [CA 88/07; 9 March 2007; Hammond J; O'Regan J and Arnold J], Mr Hseih had been trained by Fuel Espresso Limited ("Fuel") as a Barista in its espresso bar. A restraint of trade in his employment agreement prevented Mr Hsieh from working in a similar competing business within a 100m radius or setting up a similar competing business within 5km of the existing Fuel operation. Shortly after he resigned, Mr Hsieh operated a coffee cart within 70m of the Fuel operation. Fuel was successful in obtaining an interim injunction against Mr Hseih to stop him from operating the cart.

Proprietary Interest

The employer may possess a proprietary interest in trade secrets, confidential information, and its business or trade connections. The employer is permitted to protect its business connection — that is, to prevent the departing employee from enticing its clients or customers. These are the most obvious but not the only examples of legitimate proprietary interest.

A covenant against solicitation of clients or customers is not unreasonable merely because it is not limited to clients or customers of whom the employee had knowledge or with whom he or she had contact during the employment.

A restraint may be held to be reasonable if the nature of the employment is such that customers will either learn to rely upon the skill and judgment of the employee, or will deal with the employee directly and personally to the virtual exclusion of the employer, with the result that the employee will probably gain their custom on setting up in business.

If the employer possesses the requisite proprietary interest and the covenant is not too broad as to time, space, and scope of activities covered, and it merely prohibits solicitation of the employer's clients or customers, then the covenant is likely to be reasonable as between the parties and will be valid and enforceable so long as the public interest is not prejudiced.

Nature of the Business and Spatial Limits

The nature and extent of the employer's business, the nature of the employee's employment in it, and the range of business activities covered by the covenant should be considered together when examining the time and spatial limits of the covenant. The protection afforded the employer must be no more than adequate for the purpose.

Guidance may be derived in considering the reasonableness of a time restriction from an examination of the spatial restriction and vice versa.

The permissible area and duration of restraint will vary according to the circumstances of each case, and no generalisations are possible.

Spatial restrictions may not be necessary in a covenant which merely prohibits solicitation of clients or customers of the employer, whereas a covenant against competition is likely to require specific spatial limits.

A covenant against competition in a conventional employer/employee situation is generally invalid. However, such a covenant may be valid where the employee is in a position to acquire so close a personal acquaintance with the customers as to be able to sway them.

A covenant limited to prohibiting the solicitation of clients or customers of the employer is more likely to seem reasonable than a covenant prohibitive of competition generally or over a wide spectrum.

Illegality

When the Contract and Commercial Law Act 2017 is invoked, it is an important consideration that the definition of an illegal contract in section 71 of the Act "includes a contract which contains an illegal provision, whether that provision is severable or not".

If the unreasonable (and therefore illegal) restraint of trade is included in an employment contract, the whole contract would be rendered illegal and of no effect by this definition. By virtual of section 84 of the Act, section 83 of the Act applies in respect of restraint of trade clauses, however the situation is subtly different at common law: the whole contract is only unenforceable if the unreasonable part cannot be severed; it may be that only the covenant is unenforceable, leaving the rest of the contract on foot.

The potential consequence of illegality is a circumstance that the Court is bound to take into account when considering how to exercise its discretionary powers under the Act for, if it does not act, executory provisions of the employment contract such as personal grievance procedures could be rendered unavailable.

If the Court is minded to modify the objectionable provision, it may do so notwithstanding that this cannot be effected by the deletion of words from the provision but requires also or instead the insertion of words, in other words some redrafting, but not to such an extent as to render the restraint more extensive than in the contract: Contract and Commercial Law Act 2017 section 83(2), and *Cooney v Welsh* [1993] 1 ERNZ 407 (CA).

Potential to Modify

In the great majority of cases the choice facing the Court is between deleting the restraint of trade provision or modifying and enforcing it as modified. This is because the question most commonly arises in proceedings brought expressly to enforce the restraint of trade and kindred obligations as opposed to enforcing the employment contract generally.

Although section 78 of the Contract and Commercial Law Act 2017 has no direct application to contracts in restraint of trade, the Court, in deciding how to exercise its discretion to delete or modify and enforce, can be guided by the fact that Parliament attached importance to the conduct

of the parties and to the undesirability of the Court granting relief if to do so would not be in the public interest. Accordingly, if a restraint of trade is shown to be contrary to the public interest, the Court is unlikely to grant relief, except to delete the provision. However, it will not often happen that a covenant reasonable between the parties is found to be against the public interest.

Reasonable between the parties

In *Gallagher Group Ltd v Walley* [1999] 1 ERNZ 490 (CA), the Court of Appeal held:

[21] Whether a clause is in its particular circumstances reasonable and thus valid and enforceable is fundamentally a question of law but that can be answered only upon consideration of the factual setting. The Judge's assessment of the facts is not to be revisited.

Consideration

It has long been accepted that there must be valuable and legal consideration for a covenant in restraint of trade. The enforcement of a restraint of trade clause is discretionary; one factor the courts will take into account in the exercise of this discretion is whether or not the party seeking to enforce the restraint has provided consideration for it. In the case of *Fuel Espresso Limited* (see above), the Employment Court had dismissed an application for an injunction to enforce a restraint of trade, on the basis there was no consideration given for the restraint and it was therefore unenforceable. Fuel Espresso Limited ("Fuel") claimed that if it was unable to obtain an interim injunction, the damages would be probably impossible to calculate and that damages were not the relief sought. The Court of Appeal held this was a clear case for an interlocutory injunction, the restraint was reasonable and agreements were made to be kept. Mutual promises could act as consideration for each other. The Court of Appeal commented that in more extreme cases such as a low salary set against a harsh restraint, the exercise of the Court's discretion to not grant the interim injunction on the balance of convenience would be relevant but this was not the fact pattern in this case. Accordingly an interim injunction was granted.

In *Radio Horowhenua Ltd v Bradley* [1993] 2 ERNZ 1085 (EC), the Employment Court commented:

…a distinction needs to be made between the case of a restraint agreed from the start of the employment and presumably freely negotiated… and one imposed by way of variation during the employment… the Court is entitled to expect consideration to be given for the variation in the form of some valuable benefit in return for this significant restriction on the employee's freedom of action. In the absence of a consideration referable to the restraint, it is difficult to accept that the employer had a legitimate proprietary reason for demanding this protection or that it was reasonable for it to have done so. Many contracts now provide for a garden leave situation in which some remuneration continues to be payable during the period of restraint.

An agreement in restraint of trade must be supported by valuable consideration, however as held above in *Fuel Espresso Limited*, mutual promises can act as consideration for each other. If the initial agreement entered into at the commencement of employment contains the restraint clause, the other terms of the agreement are more likely to provide consideration if they provide some sort of advantage to the employee. However, this may not be true if the term is introduced later in the employment relationship. In *Dillon v Chep Handling Systems Ltd* [1995]2 ERNZ 282 (EC), it was held by the Employment Court that:

Although active intention is not a necessary ingredient in finding whether there was consideration, the lack of intention in this case emphasises the failure of the other provisions in the contract to amount to valuable consideration.

Pressure

In *Force Four v Curtling* [1994] 1 ERNZ 542 (EC), the Employment Court found that both defendant employees were placed under pressure to sign covenants in restraint of trade and that there was an inequality of bargaining position. The covenants were imposed during the currency of the employment contracts by way of an attempted variation. The pressure to sign was applied in reference to the insecurity of the two men's future employment if they declined to sign. Both were suffering from financial constraints and Mr Curtling had the additional burden of a recently purchased home and a partner who had been made redundant. The Court concluded later in its judgment when counsel for the employer submitted that both contracts (covenants for restraint in trade) were concluded after lengthy and proper consideration (in the ordinary sense of the word) by the defendants in the absence of pressure:

I do not accept this and have already found that there was pressure. Although there was adequate time for consideration and the defendants were aware of the nature of the restraint, the defendants were under financial pressure, their future employment was put in doubt, and there was an unequal bargaining position.

Duration

In *Walley v Gallagher Group Ltd* [1998] 3 ERNZ 1153 (EC), the Employment Court undertook some research into the decisions of that Court, the High Court and the Court of Appeal over the last 10 years going to the reasonableness of periods stipulated in restraint of trade clauses. It found:

The 21 cases analysed reveal that it is exceptional for a restraint of even one year's duration, let alone longer, to have been found to be reasonable. There are, however, cases where up to several years' restraint have been reasonable but these are rare.

It is clear that the party looking to enforce a restraint of trade clause must be prepared to present evidence in support of its duration. A period of restraint determined arbitrarily does not find favour with the courts. Note the comments of the Employment Court in *Medic Corporation Ltd v Barrett* (above):

I think that twelve months' protection is far too long for the purposes of mending such fences as have been damaged by the defendant's activities. No reason was given for choosing specifically twelve months instead of nine or fifteen.

And the same Court, in *Walley v Gallagher Group Ltd* (above):

Little or no evidence dealt, at least directly, with its 4-year term. The Court has no evidence, for example, why the term of restraint was set at 4 years and not, for example, at one year or 8 years. It seems clear that the rationale for the 4-year period does not include, as is not uncommon in such cases, the time necessary to effectively replace the departing employee.

The Court in the Walley case modified the restraint from 4 to 1 years' duration after finding the restraint for a period of 4 years to be one of extreme duration. This modification was upheld on appeal.

Geographical ambit

In *Walley v Gallagher Group Ltd* (above) the Employment Court listed the factors for, and against, the reasonableness of the restraint and concluded:

The restraint is comprehensive in all respects, geographic, temporal and in the range of work it precludes Mr Walley from performing. I accept there are sound reasons for the restraint to be universal. Such is the nature of the business of GGL that to restrict it geographically would be to defeat its validity. One year from the end of Mr Walley's association with GGL and with the industry in which it is engaged enables the defendant to have a fair opportunity to prepare for and meet fair competition from Mr Walley. Much of the information to which he was privy will have become obsolete or altered at the end of a year. That this will be so is illustrated by the evidence heard about the last 12 months of Mr Walley's tenure at GGL. Although GGL is no doubt justifiably proud of its leadership in the specialised market in which it develops, manufactures, and sells its products, it neither has, nor is entitled to have, a monopolistic domination of it. Mr Walley is entitled to compete fairly against GGL and to contract with others who do so. In doing so he remains bound by the contract's confidentiality and inventions restrictions. To restrain Mr Walley for more than one year from competing, let alone for the period of 4 years that the defendant still insists upon, would be unreasonable in all the circumstances.

I accept, in all the circumstances, the reasonableness of a restraint upon termination of employment and that because of the nature of the electric and security fence industry, this has to be worldwide to be effective. But in the absence of any relevant, let alone persuasive, evidence why a 4-year restraint should be upheld, the dictates of fairness and reasonableness require a substantial reduction in that term.

Scope

In *Walley v Gallagher Group Ltd* (above) the Employment Court held:

Assessing the reasonableness of the contractual restraint is essentially a balancing exercise. On the one hand are legitimate commercial proprietorial concerns and the undesirability of unfair competition by a former employee. On the other hand, there is the necessity to uphold and preserve the right of the former employee to obtain employment or otherwise engage in business in the field in which that former employee is qualified and experienced.

Mr Walley is entitled to practice his profession and to professional recognition. The restraint has substantially precluded this and will do so for the balance of its term.

In *Force Four v Curtling* (above) the Employment Court considered that the size of the boat-making industry in New Zealand (in 1994) and the high level of specialty of the two defendants were factors against the imposition of the restraints. There was a very real risk that one man would not be able to exercise the skills he had acquired and that the other would be unemployed.

Proprietary interest

In *Walley v Gallagher Group Ltd* (above) the Employment Court accepted that the other provisions in the employee's employment contract, including a comprehensive express provision concerning confidentiality and confidential information and addressing inventions, would be practicably unenforceable without the concurrent prohibition on Mr Walley having any commercial contact with the employer's competitors.

In accepting that, the Court recognised that (in part because of the small number of competitors nationally and internationally) the employer had a proprietary interest in the current and future marketing, growth and research and development strategies that Mr Walley had had access to during his employment.

In *Fletcher Aluminium Ltd v O'Sullivan* [2001] 1 ERNZ 46, the Court of Appeal held that the purpose of a covenant in restraint of trade is to be ascertained as a matter of construction of the contract. On the employer's proprietary interest and the impact of the public interest on that, the Court held:

[39] That raises the question whether, as a matter of public interest, it should be possible to restrain, by covenant on the vendor of intellectual property rights, conduct beyond the scope accorded those rights under the law. We see no reason in principle why it should not be possible. The restraint is against only the vendor. Others may compete outside the scope of the statutory protections. The restraint on that one person as vendor, so long as it is reasonable, simply permits the purchaser full enjoyment of that which has been purchased — the opportunity to commercially exploit the rights free from competition from the vendor. That is no different from where no intellectual property rights are involved as in the Dawnay, Day & Co case. From a public interest perspective to decline to allow restraint in such circumstances might deter those with the necessary capital and expertise from acquiring new inventions and designs from those lacking the resources to undertake commercial exploitation because of concern that the vendor might provide a competitor with competing technology. In this case, the transaction as a whole involved much more than simply the sale of a protected right. The vendor was to be intimately involved in the ongoing technical and commercial development of the designs.

Confidential information

Defining a proprietary interest that will not be adequately protected by the duty of confidence and/or confidentiality clauses has been highly problematic for employers seeking to enforce restraint of trade clauses.

The fact that duty of confidentiality survives the termination of an employment relationship and that, in most of the cases, the employers' legitimate interests in the protection of confidential information is adequately provided for by this and by undertakings being given, is the basis of the repeated failure of most restraint of trade clauses.

Conclusion

In most instances, it would appear from the case law that the best defence an employer can have against a former employee competing against its interests is a comprehensive express provision concerning confidentiality and confidential information.

Restraints of Trade

Our guide for Employers and Managers

Reliance on restraint of trade clauses has proven problematic for many employers. This should not be taken to mean that you should not consider including clauses of this kind in your employment agreements; rather you should have a clear understanding of the difficulties employers have faced in having these clauses enforced in the event that you are faced with doing the same.

Restraint of trade clauses are a common feature of contracts involving the sale and purchase of goodwill of a business and are a less common feature of employment agreements. The difference between the courts' treatment of restraints of trade clauses in these two situations is that a restraint of trade should be no wider than is required to protect the party in whose favour it is given. The purchaser of goodwill requires protection against the erosion of that goodwill. The employer requires protection against an employee taking advantage of the employer's trade and commercial information acquired by the employee in the course of employment.

The restraints in these two instances are not confined by the context in which they arise.

Business Central Advice is able to assist you with any matter in relation to restraint of trade clauses. Employers are advised to contact BC Advice before including restraint of trade clauses in their employment agreements.

Remember:

- Always call AdviceLine to check you have the latest guide (refer to the publication date below).
- Never hesitate to ask AdviceLine for help in interpreting and applying this guide to your fact situation.
- Use our AdviceLine employment advisors as a sounding board to test your views.
- Get one of our consultants to draft an agreement template that's tailor-made for your business.
- Visit our website www.businesscentral.org.nz regularly.
- Attend our member briefings to keep up to date with all changes.
- Send your staff to BC Learning courses and conferences designed for those who manage employees.

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