



Dispute resolution update October 2009

Preventing employees from poaching your customers

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This publication deals with employment and contractor trade restraints. It does not deal with asset based trade restraints, namely trade restraints incorporated in asset purchase agreements or share purchase agreements which will be dealt with in a subsequent publication.

Restraint of Trade clauses in employment contracts

Do you have restraint of trade and confidential information clauses in your employment and contract labour agreements? If not or if they were drafted a few years ago, then perhaps this aspect of your business should be reviewed.

A number of employer clients have commented to us in the past that “it is a waste of time and money” to include trade restraint clauses in employment agreements because they are not enforceable and if they are, then the enforcement process is too uncertain and any accompanying litigation is too expensive.

Until fairly recently, it may have been true, as a general rule, that employee trade restraint clauses were unenforceable. However in the last 3 to 5 years, **the pendulum has swung back in favour of the employer provided** the trade restraint is well drafted, is certain and fair and reasonable. In the commercial considerations section of this publication we comment on the enforcement process.

The enforcement of employee trade restraint clauses improves if such clauses are stapled with sensible confidentiality clauses and if the employer business has a confidential business system which treats customer’s identities and business profiles as confidential.

An enforceable trade restraint will prevent existing employees and ex-employees ¹ from using an employer’s confidential information and customer base as a springboard, either for a new job with a competitor or for a new business. This is achieved by prohibiting the employee from approaching existing clients, within a specific geographical location and for a specific period of time.

¹ Including existing sub contractors and former sub contractors



Care must be taken when drafting these clauses to ensure the clause is not too broad because if it is too broad or too uncertain then the Court will find that the clause is unenforceable.

Please feel free to forward this email to your friends, clients and associates if you believe that they will find the information interesting.

Background

In the past, Courts have demonstrated a willingness to support the public policy approach by construing restraints strictly against employers. However over the years, the Courts have relaxed this strict construction somewhat due to the number of restraint combinations used to cover all possible alternatives which, when it came to enforcing such clauses became too difficult to adequately enforce. The use of cascading clauses is one such instance where multiple restraints arise from one clause.

Since the late 1990's, a more direct approach has been adopted by the Courts – this was done with a view to making **restraint of trade (“RT”) clauses** more certain in their meaning and reasonable in their terms.

If the RT clause is specific, concise and reasonable, the Court's position today would be to enforce the RT clause against the employee. If this is not the case, the Court can still read down² a RT clause if it finds that the RT clause is not reasonable and/or too wide in scope or against public policy. It should be noted that the Courts will not enforce a RT clause if the restraint is designed merely to prevent competition as this is not seen as protecting a legitimate interest of the employer. The employer must show that the business could or will suffer a real commercial loss.

Current position on trade restraint clauses

When confronted in deciding whether a trade restraint is enforceable, the Courts must reconcile 2 conflicting public policy principles, namely

- (a) whether an employee or contractor should be free to use their skill and experience to the best advantage and should not be put in the position of a “slave”, and
- (b) whether the trade restraint contractual term should be observed and enforced³.

Whilst the employer is not entitled to be protected against mere competition by an ex-employee⁴, the employer is entitled to be protected against the advantage acquired by an ex-employee over the employee's customers or clients⁵.

Provided the relevant trade restraint clause is effectively drafted, the Courts will enforce a trade restraint clause to discourage employees from using their employer's confidential customer list as a springboard for a new business or for a new job provided the trade restraint is in writing.

Two of the main reasons why trade restraint clauses have been held to be unreasonable are because the trade restraint clause

² Section 4 of the *Restraint of Trade Act 1976* enables the Court to do so.

³ *Herbert Morris Ltd v Saxelby* [1915] 2 Ch 57, *Attwood v Lamont* [1920] 3 KB 571, 577.

⁴ *Ibid* at 18.

⁵ *Ibid* at 30, *Dewes v Fitch* [1920] 2 Ch 159 per Warrington LJ at 181.



- (a) has so many permutations that the clause is found to be uncertain (cascading trade restraint clauses), or
- (b) seeks to prevent an employee from seeking re-employment in the same or like market segment as the market that the previous employer operated in.

We are sure that many of you have seen the cascading trade restraint clause in which there are numerous various trade restraint periods and numerous geographical restrictions used. These clauses are now discouraged by the Courts because they are just too uncertain in that the employee does not know exactly what they can and cannot do – and as such they are unclear and unfair.

Other trade restraint clauses have failed because the restraint is too broad in that it attempts to keep the employee out of a specified industry. For example if an accounting firm or a legal firm employer had a trade restraint clause that prevented the employee from being employed in the accounting profession or the legal profession for a 6 months period in the CBD of Sydney, then such a clause would be held to be void because of public policy reasons. The Courts would find it unfair and unreasonable because it prevents the employee from seeking and obtaining gainful employment for the trade restraint period. Such clauses however can be effective in a given situation, it depends on the diversity of the industry concerned, the seniority of the employee, their skill set etc. However, as a general rule, structuring a trade restraint on an industry or market segment based model invites legal uncertainty and if the clause can be structured in a different way then it should be.

If there is no written trade restraint or if an existing trade restraint clause is not enforceable, then an ex-employee or ex contractor would, post termination of employment⁶, be entitled to compete in their own right or work for a competitor using as a springboard, your customer base and your confidential information which they acquired during the course of their employment with you.

In NSW, the Courts⁷ determine the validity of the trade restraint by focusing on the actual or likely breach rather than on imaginary or potential breach. The employer has the onus of showing and proving that the trade restraint clause is valid and should be enforced⁸. This means that the employer must ensure that the trade restraint clauses being included in the employment contract are reasonable and are not too wide in scope. As long as the restraint is not against public policy, it is considered valid. A trade restraint that restricts or unfairly limits the ability of an employee to work will be found to be void on the grounds of public policy.

The 5 main principles

The leading case in this area was decided in 2004 and provided 5 principles which the Court will consider when determining the reasonableness of a restraint:

1. An employer must have interests capable of protection by a restraint such as retention of customers and trade secrets;
2. Protection of trade secrets by a restraint is reasonable;
3. A contractual agreement as to what constitutes a reasonable restraint will be given considerable weight but is not conclusive of whether the restraint is valid;

⁶ Note that during the period of employment an employee owes a fiduciary duty to an employer which can prevent an employee from poaching or directing customers during the period of employment – but this duty ceases on termination of employment.

⁷ Pursuant to the *Restraints of Trade Act 1976* as well as the common law

⁸ *Herbert Morris Ltd v Saxelby* [1916] 1 AC 688, 715.



4. The validity of the restraint is to be assessed at the time of the contract of employment being entered into rather than what has actually been done pursuant to the contract of employment; and
5. The Court may not re-write the covenant⁹ but may “amputate it” to ignore the fact that the restraint goes beyond what is reasonable.

More recently in 2008¹⁰, the Court found that 2 issues had to be determined, firstly, whether there had been a manifest (plain or obvious) failure by the employer to make the restraint reasonable, and secondly if the clause is reasonable, then as a matter of discretion, what order as to invalidity should be made.

The Courts determine whether a trade clause is reasonable on a case-by-case basis by balancing the employer’s legitimate business interests with the employee’s right to earn a living. Consideration must be given to the width and the duration of the restraint. An employer must ensure that what is being restricted is certain and reasonable.

Independent Contractors and restraint of trade clauses

Restraint of trade clauses can also be used where the services are being provided by an independent contractor. Whilst at law an independent contractor is very different to an employee, the same legal tests are used when determining whether trade restraint clauses are valid or not – namely is the clause reasonable or is it too broad in its scope?

In circumstances where an independent contractor does not agree to a trade restraint clause, then the employer may be able to overcome this by requiring the contractor to sign a well drafted confidentiality agreement instead.

What action can you take to enforce a trade restraint clauses?

In circumstances where an employer discovers that an ex-employee has breached a restraint of trade clause in the employment contract, then the employer should immediately obtain legal advice in determining whether action should be taken to enforce the trade restraint.

Commercial considerations in enforcing an employee trade restraint

Some employers with numerous employees enforce trade restraints for the purpose of keeping other employees “in check”. There are usually larger employers who are anxious not to send mixed messages to their work force that they can just ignore the trade restraint clause in the agreement. Such employers usually have systems in place where the employee trade restraints are regularly reviewed and consequently are usually enforceable.

Other employers are more pragmatic in their approach. Issues to be considered commercially include:

- (a) whether the departing employee can “really” commercially harm the former employer’s business and revenue. Situations can arise where the employee’s new employer has a commercially inferior product range and reputation such that the commercial risk to the former employer’s business is minimal;

⁹ This is done by the Court whilst exercising its power under section 4(1) of the *Restraints of Trade Act 1976* (NSW).

¹⁰ *Tullett Prebon (Australia) Pty Ltd v Purcell* [2008] NSWSC 852.



- (b) what impact would a failure to enforce have on other employee expectations should they also leave and breach their trade restraint and conversely, what impact does enforcement have on other employees;
- (c) whether it is necessary to involve customers to give evidence and if so, what harm does that do. Many employers do not want to advertise their “dirty washing” to their customers nor involve customers in potential litigation¹¹;
- (d) whether any successful litigation would provide any lasting commercial benefit. Many employment trade restraints are for a limited period of between 6 and 12 months. Unfortunately, if the enforceability of a trade restraint is contested then the restraint may have expired by the time the matter comes to court for a hearing;
- (e) whether employer resources would not be better expended in “bedding down” existing customers by improving the existing relationship with customers. Often an immediate and pro-active approach by the employer to an “exposed” customer prevents a successful poaching of an important customer. Whilst personal relationships are important, a customer is often a customer because of the quality of the product and service, its utility to the customer and related pricing considerations.

Of course numerous other considerations arise and in determining the appropriate legal response, it is essential for all alternatives to be considered. Employers invariably choose not to litigate unless there are compelling reasons to do so. If there are commercial alternatives then these should be evaluated and implemented where feasible.

Joint commercial and litigation approach

Sometimes, employers will adopt a litigious stance for the purposes of reminding an employee of their contractual obligations. This often reflects the commercial reality that many employees have little or limited capacity to litigate – in other words – the employer uses its greater financial resources to coerce contractual compliance by the employee.

Invariably this tactic is successful, especially when it is pragmatically used in conjunction with one of the commercial remedies identified above.

Under this strategy and provided the employer has reasonable prospects of success if the matter was to be litigated, a letter is sent to the offending employee by the employer’s lawyers outlining the contractual requirements, the alleged breach and requiring an undertaking in writing by the employee that they will cease and return to the employer any confidential information, including all copies of customer lists, in the former employee’s possession. The letter allows a limited period of time to comply and advises that unless there is compliance then immediate proceedings for an injunction and damages will be commenced against an employee by the employer.

This tactic is invariably successful if the employee is “trying it on” – however, if the new employer of the employee is “behind the scenes” then this approach can also lead headlong into litigation.

Legal considerations in enforcing an employee trade restraint

On occasions, and more often in a competitive market place (such as the financial services market place), a departing employee has planned the customer assault with the new employer. Whilst you may regard such tactics as commercially disingenuous, it happens – sometimes all too frequently.

¹¹ Customers who have been approached are sometimes subpoenaed to give evidence or to produce documents and correspondence etc.
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Where a former employee is being encouraged and financially assisted by new employer (including access to the new employer's lawyers) to "test" the effectiveness of a trade restraint, then careful commercial and legal consideration must be given as to the appropriate response by the affected employer.

If the competitor has encouraged a breach of contract by the former employee then the competitor may be liable in tort to the previous employer for inducing a breach of contract by the former employee. The provocative circumstances surrounding cases of this nature requires a pragmatic and considered approach by the affected employer.

It is often this type of case that results in litigation because the competitor's actions are so provocative and because the affected employer becomes concerned if "it lays down and does nothing", then other employees may be similarly approached such that there is widespread poaching of the former employer's customer base.

Subject to the evidence available, such cases often result in the former employer commencing proceedings not only against the relevant employee for breach of contract but also against the new employers for inducing and encouraging such breach.

If litigation is commenced, then the Court has identified that 5 issues are to be determined when considering whether the Court should grant an interlocutory injunction. These are:

1. Has there been a timely application for interlocutory relief? These applications must be sought promptly.
2. Is there evidence of breach of the restraints by the former employee?
3. Is there an arguable case that the restraint covenant is valid? Alternatively can the restraint be read down? If the Court finds that the RT clause is too broad and wide in scope, it can reduce the restrictions applied to make the clause enforceable¹².
4. Does the balance of convenience lie in favour of the granting of the injunction to the employer? This is a normal injunctive test and essentially requires the Court to be convinced that the injunction is necessary to maintain the status quo.
5. Are damages an adequate alternative remedy to the granting of an injunction? The Plaintiff needs to show that receiving compensation or damages is not adequate to remedy the breach of the restraint¹³.

Sometimes, claims are also made for damages, equitable compensation and/or an account of profits but it is generally difficult to assess these claims as an employer will need to prove that the ex-employee's gain is the employer's loss¹⁴.

Take home message

In summary the "take home" message of this update is that an employer should ensure that a properly drafted trade restraint clause is included in its employment contracts. The clause cannot be too broad in its scope or unreasonable in its application. If you do not already have a trade

¹² This is done pursuant to section 4(1) of the *Restraints of Trade Act 1976* (NSW).

¹³ Austin J in *Hi-Tech Contracting Limited v Jane Lynn*, unreported, Supreme Court of NSW, 31 May 2001 held that damages would not be adequate as it would be difficult for the Court to assess the damage which might be suffered where the ex-employee has engaged in specialise services and has deliberately breached a valid restraint of trade clause by commencing employment with a competitor and ordered an injunction against an employee.

¹⁴ *Hunter Business Finance Pty Ltd v Australian Commercial & Equipment Finance Pty Ltd & Ors* [2007] NSWSC 1323. {00104440}/TAR/PEM – October 2009



restraint clause in your employment contracts then these should be included in order to properly protect your business interests. You cannot however unilaterally change your existing contracts and you should contact us as to the appropriate manner to allow this change to occur.

MBP Legal can assist in drafting enforceable trade restraint clauses to be included in employment contracts or alternatively provide advice in responding to an ex-employee breaching the trade restraint terms of an existing employment contract