Drafting Restrictive Covenants In Employment Contracts

Introduction

Restrictive covenants are commonly used in contracts of employment to prevent employees from taking advantage of resources or goodwill obtained during their employment, and using such tools to unfairly put themselves in competition with their former employers after resignation. However, these clauses are notoriously difficult to enforce, as Courts are likely to find them void for being in restraint of trade unless they can be shown to be just wide enough to reasonably cover the employer’s legitimate interests.

How then should an employer go about drafting effective restrictive covenants? This Client Update takes a look at the factors one must keep in mind when drafting restrictive covenants, and the steps one should go through in the drafting process, while highlighting examples from recent case law.

Restrictive covenants in employment contracts have in fact been quite prominently featured in recent jurisprudence. In Singapore, the Court of Appeal released two landmark decisions regarding restrictive covenants in Smile Inc Dental Surgeons Pte Ltd v Lui Andrew Stewart [2012] SGCA 39 (“Smile Inc”) and Mano Vikrant Singh v Cargill TSF Asia Pte Ltd [2012] SGCA 42 (“Cargill”). Apart from these cases, we will also take a look at recent decisions from other jurisdictions, such as the English decision of CEF Holdings Ltd v City Electrical Factors Ltd [2012] EWHC 1524 (QB) (“CEF Holdings”) and the Australian decision of Birdanco Nominees Pty Ltd v Liam Paul Money [2012] VSCA 64 (“Birdanco”).

Restraint of Trade Clauses

If a restrictive covenant is found to be a restraint of trade clause, it is then subject to the restraint of trade doctrine, in that it has to pass the test for reasonable restraint of trade before it will be upheld. It is thus important to first establish whether the clause you are drafting is in fact a restraint of trade clause.

A traditional restraint of trade clause is an outright prohibition imposed on the employee against competing with his employer. For example, in Smile Inc, the restrictive covenants
stated that the employee dental surgeon “shall not practice within a 3km radius distance from [the employer’s clinic]” and “will not… canvass, solicit or procure any of [the employer’s] patients”. Such clauses are in direct restraint of trade.

However, the Court in Cargill warned that it would consider the true nature of any restrictive covenant, and that framing a clause as a disincentive would not shield it from the application of the restraint of trade doctrine.

The dispute in Cargill arose from the terms and conditions (“T&C”) for deferred bonus payments, which stated that a part of the bonus amount earned by the employee would be paid in stages, ie a deferred payment. The amount of bonus to be deferred (“Deferred Bonus”) depended on the total bonus amount earned by employee. The T&Cs further stated that the Deferred Bonus was only payable so long as the employee’s employment was not terminated and he did not join a competitor for two years post employment. In effect, the Deferred Bonus due and payable to the employee was to be forfeited if the T&Cs were breached (“Forfeiture Provision”).

The Court of Appeal held that although the T&Cs may not be a direct restraint on trade, it did constitute an indirect restraint on trade.

(a) In reaching its conclusion, the Court of Appeal reviewed the T&Cs to first determine whether they were a provision that forfeited accrued benefits or whether the T&Cs were a form of a loyalty bonus.

(b) Based on a review of the clauses, it was held that the Deferred Bonus payments were vested, due and payable to the employee as at the termination of his employment. This meant that any conditions attached to the payment of the vested amounts, where such conditions prohibited the employee from joining a competitor, were another form of a restraint on trade.

(c) The Court also distinguished the Forfeiture Provision from a loyalty scheme where additional moneys are paid to the employee if he does not join a competitor for a certain period. The Court clarified that although loyalty payments may be permissible Forfeiture Provisions will be considered as a restraint on trade and will need to pass the Courts’ scrutiny for such restraints.

The primary driving force in the Court of Appeal’s decision was that the benefits had vested in the employee, ie they were accrued at the time the T&Cs kicked-in, and the employer then made an attempt to forfeit them. This provides employers with added food for thought with respect to their existing employment contracts and provides a recommendation to not vest the bonus awards until and unless a list of pre-conditions are met.
A similar situation arose in the Australian case of Birdanco. The restrictive covenant there prohibited the employee of an accounting firm from providing accounting services to the employer’s clients after termination of his employment, or else he would be liable to pay 75% of the particular client’s fees received in the preceding year. This was also held to amount to a restraint of trade.

While a provision for forfeiting benefits or paying a penalty will be held as being an invalid restraint, a payment for continuing loyalty will be permissible. What this means is that care must go into how employment contracts, and in particular restraint provisions, are crafted. The relevant provisions must be carefully modeled to ensure that it is not a restraint in disguise and will be enforceable post-termination.

## Legitimate Interests

The test for assessing whether a restraint of trade clause will be upheld is uncontroversial.

(a) The Court will look into whether there is a legitimate proprietary interest requiring protection in relation to the employee’s employment.

(b) If so, the Court will examine whether the covenant is reasonable in reference to the interests of the parties and the interests of the public.

(c) The covenant will only be enforced if it goes no further than necessary to protect the legitimate proprietary interests concerned.

It is thus important to establish that there is, in fact, a legitimate business interest to be protected. When drafting a restrictive covenant, one must be aware of what constitutes a legitimate interest.

## Goodwill

The most common interest sought to be protected is an employer’s goodwill from its clients or customers. In certain situations, the employee would have built up a relationship with the employer’s clients during the course of his employment, and an employer would seek to prevent him from taking unfair advantage of this after his resignation.

The case of Smile Inc involved a dental surgeon restricted from practicing in certain areas and dealing with his ex-employer’s clients after his employment ended. The Court of Appeal stated that medical practitioners have a special and intimate knowledge of the patients of the business, and that this constitutes a legitimate proprietary interest. It further held that such goodwill applies to other professionals who deal with clients, such
as accountants or lawyers, who may come to represent the persona of the firm to their particular clients.

In *Birdanco*, the Court highlighted that one need not be a professional practitioner to be caught by a restraint of trade clause. This case involved a restrictive covenant placed on a trainee accountant. It was found to be sufficient that he had provided recurring services that would give him a reasonable level of knowledge of the company affairs, and a corresponding level of confidence by the client.

**Confidential information**

In the course of his employment, an employee might obtain confidential information relating to the operation of a business. Such ‘business secrets’ are widely regarded to be a form of interest which the employer is entitled to protect. An employee should not be allowed to use such confidential information for his own benefit after leaving his employment.

It should be clarified, however, that confidential business information should not be confused with general skills and job experience picked up over the course employment, which are not protectable through restraint of trade.

**Workforce**

In *CEF Holdings*, the Court recognised that an employer may be entitled to protect the stability of its workforce by imposing a covenant precluding the solicitation of employees. Although the restrictive covenant was eventually found unenforceable due to unreasonableness, it was acknowledged that employees working in teams might obtain special knowledge of or influence over their team-mates. Replacing large parts of entire teams might be difficult for the employer, and it may try to protect itself against such an attempt at solicitation.

**Reasonable Protection**

As stated, a clause in restraint of trade is only valid if it is reasonable and goes no further than necessary to protect the relevant interests. This is perhaps the most complicated stage of drafting, as the reasonableness of any protection differs according to the specific circumstances of the employer-employee relationship.

Bigger is not always better when it comes to restraint of trade; in fact, the more conservative the drafting, the more likely the clause will be effective. While it may be instinctive to draft restrictive clauses widely in order to ensure that former employees do not later become competitors, such efforts may backfire if the clause is found to be
unreasonable and thus unenforceable. The Court in *Smile Inc* specifically warned against trying to get the maximum protection an employee will agree to, stating that the Court would be unlikely to read down such clauses to a reasonable scope in order to avoid having the restraint of trade clause struck down.

In order to restrict restraint of trade clauses to a reasonable scope, one may consider using the following factors.

**Time and geography**

Time and geography are the two factors most commonly used to restrict the scope of restraint of trade clauses. Their inclusion as limiting elements is quite crucial to creating a valid restrictive covenant.

In *Smile Inc*, the Court highlighted that a restraint of trade which operates for an indefinite period of time is, barring exceptional circumstances, necessarily void and unenforceable. No matter what interest the employer is trying to protect, it is highly unlikely that the protection should last beyond a few years. Client goodwill will diminish in time, as will the utility of information obtained. In *Smile Inc*, the restrictive covenants preventing the employee dental surgeon from practicing in certain areas and dealing with his ex-employer’s clients was rejected for failure to specify a time limit.

The exact number of years the relevant interest can be protected for depends on the circumstances. The Court will take into account expert opinions on the matter, so when drafting a restrictive covenant, one may consider appointing a trade expert to determine the appropriate amount of time the employee should be restricted from competition.

Similarly, restrictive covenants with no restriction as to geography are likely to be rejected by the Court. Even goodwill has limited geographical scope, as a business is likely to attract clients in a certain area, or to be competitive only in certain regions. This was the case in *Cargill*, where the forfeiture clause sought to prevent the employee from joining any of his employer’s competitors. The forfeiture clause was not limited to any geographical area and/or the type of competitor, ie it applied across the globe and against all companies viewed as competitors by the employer. It was thus found to be in unreasonable restraint of trade.

The Court in *Smile Inc* had similar criticism for a restrictive covenant which sought to prevent the employee dental surgeon from practicing within 3 kilometers of his any of his employer’s chain of clinics. It was found that it would not be reasonable to restrain the employee from practicing within a radius of clinics which he had never practiced at.
Demographic

Where the interest that is to be protected is the goodwill of the employer’s clients, it is important to restrict the protection to a particular set of clients. While employees may establish business relationships with clients in the course of their employment, it is unlikely that their influence would stretch across all of the employer’s clients.

We may look to *Smile Inc* again for an example of this, where the restraint of trade was limited to a 3 kilometer radius from the employer’s clinic. Despite this limit, the clause was still found to be unreasonable as the scope of the patient pool should have been limited to the employee dental surgeon’s former patients only. Of course, in other retail sectors, a geographical limit may be sufficient as there is no fixed group of clients, but this depends on the industry and facts in question.

On a related note, when attempting to restrict a former employee from acting in direct competition, one must also specify the business from which he is prohibited. After all, one cannot seek to prevent an employee from pursuing a career in an unrelated field. For example, in *Cargill*, a restraint of trade was found to be unreasonable as it sought to prevent an employee from joining any of the employer’s competitors, but failed to limit it to the particular business that the employee was involved in (in this case, trade and finance).

Business resources

A restraint of trade clause may prohibit an ex-employee from using resources obtained during his employment. However, such resources must be clearly defined and distinguished from company resources in general.

In *CEF Holdings*, the employer attempted to prevent the employee from poaching other staff members. However, the restraint of trade clause was rejected as it did not limit the pool of employees to those in his team, or with whom he had direct contact. In the same case, the employer tried to justify a non-competition covenant by claiming that it had to protect confidential information. The Court then responded that the employer should have set out a clear covenant setting out what is confidential together with a prohibition against using this material.

Implied Duties

It should also be remembered that all employees owe their employers an implied duty of good faith and loyalty, even if it is not specified in their employment contract. This duty governs what the employee cannot do during his employment, and generally does not...
overlap with restrictive covenants, which govern what the employee cannot do *after* his employment.

However, where a restrictive covenant expressly refers to the employee’s conduct *during* his employment, it necessarily supersedes any implied duty of good faith and fidelity. Drafters should thus ensure that restrictive covenants do not end up narrowing the scope of the duty owed to the employer. This was the case in *Smile Inc*, where the Court had to consider whether a clause expressly providing for the scope of prohibited activities during the employee’s employment overrode the employee’s duty of good faith.

## Concluding Words

When drafting restrictive covenants, it is essential that the scope of protection should only be as wide as necessary to protect the legitimate business interests of the employer. Otherwise, the covenant will be found to be in unreasonable restraint of trade, and thus void and unenforceable.

This is especially so in employment contracts, where the Court adopts a stricter approach in recognition of the inequality in bargaining power. Restraint of trade clauses should thus be drafted in a focused and conservative manner, taking into account the exact interests that they are meant to protect, rather than casting the net as wide as possible in hopes of catching all potential competitive activity.
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