Employment & Benefits

What Makes Up A Restrictive Covenant:
The Courts' Position on Interpretation and Severance

Introduction

Restrictive covenants are common features in employment contracts that are often the subject of dispute. These provisions seek to protect the employer's client base, goodwill, suppliers, employees or competitive advantage after the termination of the employee's employment. However, what most employers may not realise is that under Singapore law, these types of restrictive covenants are generally void for restraint of trade *unless* it can be shown that they are reasonable in their protection of a legitimate proprietary interest.

This does not mean that these types of restrictive covenants are void or are inherently unenforceable, but it does mean that *employers bear the burden* of first proving to the Courts that (a) they have a legitimate proprietary interest worth protecting; and (b) the restrictive covenant is drafted in a reasonable manner to protect the legitimate proprietary interest and no more. This also means that overly expansive restrictive covenant clauses would be unlikely to be enforced by the Courts. It is thus imperative that employers understand the elements of a restrictive covenant and the issues that may affect the enforceability of such covenants.

Recently, the UK Supreme Court has issued a key decision on restraint of trade. In *Tillman v Egon Zehnder Ltd* [2019] UKSC 32 ("***Tillman v Egon***"), the apex court examined the enforceability of a restrictive covenant in an employment contract, focusing on the issues of how it would approach the interpretation of such covenants, as well as when unlawful provisions in a restrictive covenant can be severed to leave the remainder valid and intact.

In this Update, we take a look at what makes up a restrictive covenant and delve deeper into the topics of interpretation and severance. Taking our lead from the UK position, we also discuss the comparative approach that has been taken by the Singapore courts, and what employers should keep in mind when drafting or dealing with restrictive covenants in their contracts of employment.

Tillman v Egon

In *Tillman v Egon*, the restrictive covenant in question sought to restrain the Respondent employee from certain activities for a period of 6 months from the termination of her employment. One of the covenants stated that the Respondent would not "directly or indirectly engage or be concerned or interested in any business carried on in competition with any business of [the employer]".

The Supreme Court held that the restrictive covenant was an unreasonable restraint of trade, but was willing to sever the offending portion to leave the remainder of the clause valid.

Specifically, it was found that the word "interested" prevented the Respondent from even a minor shareholding in a competing business, rendering the restriction unreasonable in terms of its protection of the Appellant employer's interests. The Court went on to hold that the doctrine of severance allowed it to remove the words "or interested" from the provision. The remainder of the restrictive covenant was thus found to be valid.

Restrictive Covenants

The law on restrictive covenants is fairly established both in Singapore and the UK. To be enforceable, a restrictive covenant must be designed to protect a legitimate proprietary interest of the employer. The restraint on trade must be reasonable in scope with regard to the interests of the parties and the public, meaning that it must provide no more than adequate protection over the respective interests.

A restrictive covenant is made up of the following parts:

(i) The restriction that is imposed on the employee;
(ii) The interest that is being protected; and
(iii) The scope of and limitations applied to the restriction.

Restriction

The restriction imposed can take on many forms. This includes:

(i) **Non-solicitation**: A restriction on contacting customers or clients of the former employer with a view to obtaining their business.
(ii) **Non-poaching**: A restriction on soliciting or poaching the former employer's employees.
(iii) **Non-dealing**: A restriction on dealing with the former employer's customers or clients, such as by providing services or products at all.
(iv) **Non-competition**: A restriction on joining a competing business or participating in the same field of business, such as through shareholding, employment, or establishing one's own business.

Interest

Employers have certain rights that legitimately require protection. While this ultimately depends on the nature of the business, these legitimate interests may include:

(i) Trade connections with customers, clients or suppliers;
(ii) General goodwill;

(iii) Trade secrets and confidential information; and
(iv) Stability of workforce.

Limitations

If a restriction applies without any limitation or refined scope, the courts are unlikely to find it reasonable with regard to the interests that it seeks to protect. Restrictive covenants would thus require the addition of certain limitations to define the boundaries of the restriction, such as:

(i) Geography;
(ii) Time period;
(iii) Area of business; and
(iv) Scope of customers/clients.

Interpretation

When determining the validity of a restrictive covenant, interpretation plays a major role. The precise meaning of the provisions must be understood before one can assess the reasonableness of the restriction.

It is advisable for employers to seek legal advice so as to be clear and precise when drafting restrictive covenants. Uncertainty or ambiguity in drafting is likely to lead to problems when seeking to enforce a covenant. In addition, while employers may be tempted to draft a restrictive covenant widely and in general terms so as to 'cover more ground' or to 'enhance' the scope of protection provided, they should avoid that and instead spell out exactly and with precision what post-termination activities are prohibited, for how long, in what area, etc.

This is because the wider the scope of the protection, the more likely the courts will find the restrictive covenant to be unenforceable as it would amount to being an unreasonable restraint of trade.

In *Tillman v Egon*, the Appellant employer argued for an alternative construction of the offending restrictive covenant by submitting that the restriction against being "interested" in a competing business did not actually prohibit the Respondent from holding shares in the specified businesses. The Appellant relied on the validity principle in construing agreements, which proceeds on the premise that parties to a contract will have intended for it to be valid, such that a provision which has more than one interpretation should be interpreted in the manner which would result in validity.

The Supreme Court held that the validity principle would only come into play where the alternative construction of the provision is "realistic". The Court endorsed this middle ground between previous descriptions of the principle, rejecting the tests that the alternative meaning should be "equally plausible", or that there need only be "an element of ambiguity".

On this basis, the Court found that the Appellant had failed to put forward a realistic interpretation of the word "interested". The phrase had long been used in non-competition covenants and treated as prohibiting shareholding.

The Singapore courts have taken a position that is largely in line with the position in *Tillman v Egon*. In *Powerdrive Pte Ltd v Loh Kin Yong Philip* [2019] 3 SLR 399, the Singapore High Court held that the validity principle would only apply where there are two "reasonable" interpretations of a restraint of trade provision, one of which would render it unenforceable and the other would allow it to be upheld. The Court emphasised that it would not bend backwards to come to some sort of interpretation that would save the provision from unenforceability.

Here, the former employees had been hired as trainers for armour vehicle drivers, and the restrictive covenant in question retrained them from "working for a rival company". The Court rejected the employer's submission that the provision only restrained them from being employed as an armour vehicle driver trainer, finding that this would require the re-writing of the clause rather than mere interpretation.

Notably, the Court warned against employers starting with a widely worded restraint of trade provision and, only when challenged, arguing that the provision should be construed narrowly in context so as to save its enforceability.

Severance

When a restrictive covenant is found to be unreasonable in restraint of trade, it may still be rescued through the doctrine of severability. The court has the power to remove the unlawful or unreasonable provisions from the clause, leaving the remainder of the restrictive covenant intact and enforceable.

In the past, the courts have adopted different approaches towards the application of severance in the context of restraint of trade cases. The Supreme Court in *Tillman v Egon* has since resolved this by endorsing the approach in *Beckett Investment Management Group Ltd v Hall* (2007) ICR 1539 (CA) ("***Beckett v Hall***"), which sets out three criteria for severance:

(i) The unenforceable provision must be capable of being removed without the necessity of adding to or modifying the wording of what remains – this is often referred to as the "blue pencil test";
(ii) The remaining terms must continue to be supported by adequate consideration; and
(iii) The removal of the unenforceable provision must not so change the character of the contract that it becomes not the sort of contract that the parties entered into.

On the facts, the Court held that the words "or interested" were capable of being removed without modifying the wording of the clause, and that the removal of the shareholding restriction would not

generate any major change in the overall effect of the restraints. The words were accordingly severed from the restrictive covenant, leaving the remaining provision valid and enforceable.

The *Beckett v Hall* test for severance has been endorsed in the Singapore High Court case of *Lek Gwee Noi v Humming Flowers & Gifts Pte Ltd* [2014] 3 SLR 27. The Court in this case specifically rejected the proposition that a different test should apply to severance in employee covenants.

The Court here also warned against "cascading clauses", which are restrictive covenants that provide for a variety of durations or geographical scopes. These are designed to accommodate the "blue pencil test", such that the courts may strike out unreasonably long durations or geographical scopes of restraint while preserving the restrictive covenant if at least one of the durations or geographical scopes passes the test of reasonableness. The Court expressed disapproval of the effect of such clauses on a vulnerable employee, as it would leave them uncertain as to which cascading restriction binds them until the matter is settled in court, and that severance in such a case would not be consistent with public policy.

More recently, in *DyStar Global Holdings (Singapore) Pte Ltd v Kiri Industries Ltd* [2018] 5 SLR 1, the Singapore High Court applied the "blue pencil test" on a restrictive covenant which prohibited the solicitation of "any person who is or has at any time during the Period been a customer, client, identified prospective customer or client, agent or correspondent of any member of the Group". The Court was willing to sever the words "identified prospective customer or client", leaving the remaining provision reasonable in its restraint of trade and thus enforceable.

Concluding Words

Unless drafted properly, restrictive covenants are problematic provisions as they are frequently challenged in court and thus come under judicial scrutiny over whether they should be held unenforceable for being in restraint of trade. Employers should thus seek proper legal advice when drafting such clauses, which have to be *specific and targeted*. It would be safe to say that the days of generic, "boiler plate", "cut and paste" expansive types of restrictive covenants being enforceable are over. While the courts will assist employers in protecting their legitimate proprietary interests, the court will not allow employers to use these types of clauses to stymie normal economic competition and the free movement of labour in a free-market economy.

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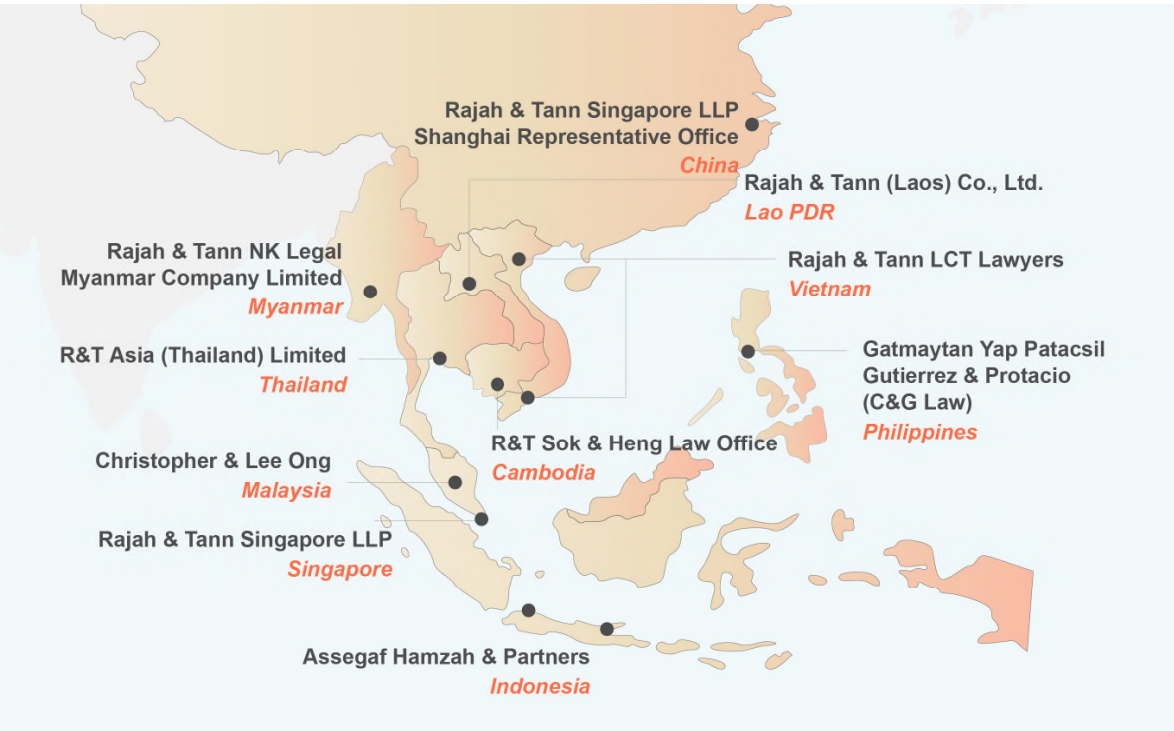

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