

RESTRICTIVE COVENANTS: PROPOSED LEGISLATION DITCHED

Paul Goulding QC, Blackstone Chambers and Jennifer Millins, Mishcon de Reya

The proposal for legislative intervention on restrictive covenants

In May 2016 the Government published a call for evidence on restrictive covenants. The proposal was one of a raft of measures which, the Government said, would promote innovation and flexibility within the labour market through The National Innovation Plan.

Nothing further was heard about the proposal until 7 February 2018, when the Government published its response to the Taylor Review: *"Good Work: a response to the Taylor Review of modern working practices"*. Eagle-eyed readers of that paper will have found that the Government's response to the call for evidence on restrictive covenants unexpectedly appears on page 58.

While the announcement is somewhat buried, it is nevertheless welcome news that the Government now agrees with ELA that legislative intervention is unnecessary. The Government writes that "restrictive covenants are a valuable and necessary tool for employers to use to protect their business interests and do not unfairly impact on an individual's ability to find other work. Common law has developed in this area for over a century and is generally acknowledged to work well. [...] Having built up a picture of the UK experience via this call for evidence, we have decided it is not necessary to take any further action in this area at this stage".

Call for evidence and ELA's response

The authors were members of ELA's working party which in July 2016 produced a comprehensive response to the call for evidence and its premise: whether restrictive covenants "stifle innovation".

The call for evidence appeared to restrict its focus to post-termination non-compete restraints in employment contracts. ELA's response highlighted the importance of understanding the variety and complexity of restraints in practice. The response explained the diverse range of covenants available to prevent unlawful competition, including restrictions on competition during the currency of employment and the use of indirect restraints such as those found in deferred remuneration schemes.

In addition, the response looked at the history and current state of the law in the UK and offered comparative information from other jurisdictions. It described how lawful innovation had been carefully safeguarded through several centuries of case law.

The response explained:

- the doctrine of restraint of trade
- the balance between competing public policy considerations
- how the courts deal with the presumption of unenforceability, and
- the onus is on the employer to prove enforceability.

Far from requiring legislative intervention, the response concluded that the common law test for the enforceability of restraints is flexible, adaptable and responsive to the changing needs of society.

At the heart of the call for evidence was the proposition that “the law of confidence will prevent current or former workers from personally using their employer’s trade secrets or confidential customer lists”, negating the need for other restraints. It was therefore important to clarify the long-established position that an employee’s duty not to misuse confidential information often provides inadequate protection for an employer and that covenants may be necessary to police compliance.

Finally, the call expressed concern that restrictions may impede innovation and obstruct workers, even those with original ideas, from establishing new businesses in the same field. There is ample evidence in recent case law to suggest that the courts are alive to the evolving marketplace and that the nature and scope of the enterprise concerned tempers their assessment of reasonableness.

In that context, ELA's response observed that: "an inventive employee with an idea s/he wishes to develop by establishing a new business would no doubt wish to be entirely unfettered in the ability to do so. Once that business is set up and employees need to be hired, s/he might take a very different view of the possibility of those employees being entirely free, having learned the detail of the business, its intellectual capital and its customers, to leave and immediately set up in competition. Furthermore, where finance is needed to establish the new business, an investor will not be encouraged if the people that it has invested in are free to leave and establish a competing business".

The views of employers and entrepreneurs

Prompted by the call for evidence, Mishcon de Reya's employment team sought its clients' views, inviting them to be part of a debate which could dramatically change laws that have been evolving for well over a century. The view that legislative intervention is not required to protect innovation was supported by employers and entrepreneurs alike. The results support the view that the law as it stands succeeds in striking a balance between an individual’s freedom to work and an employer’s right to protect its business.

The survey highlighted the Government's misapprehension as to how trade secrets and confidential information are protected, with 76% of employers fearing that confidential data could be taken to a competitor freely if the Government interfered in the use of restrictions.

Over three quarters of respondents disagreed with the Government's assumption that restrictive covenants stifle innovation. In fact, all the entrepreneurs surveyed recognised that restrictive covenants are valuable in protecting businesses from unfair competition, and only 6% of respondents considered that covenants do not offer such protection.

The vast majority of entrepreneur respondents feared that government intervention would adversely impact their ability to attract or retain investment. Far from promoting innovation, the Government's plans may have had the opposite effect. As the response explained: "Our experience is that a system where an employee may seek and accept significant funding to develop a business and is then completely free to leave and set up in competition without any restraint is not likely to increase investors’ enthusiasm to support new ventures."

Dyson v Pellerey: a recent example of the court’s approach to restrictive covenants

The recent case of *Dyson v Pellerey* demonstrates the enduring value of well-drafted covenants, and illustrates the well-honed common law principles applicable to the interpretation and enforcement of covenants. The first instance judgment, which has only just become publicly available, is a timely reminder of the court’s adeptness at carefully balancing the interests of employer, employee and start-up competing business in a highly innovative, technology-based industry.

The facts

The Dyson group is well-known for its innovative vacuum cleaners and air-blade hand driers. Mr Pellerey worked for Dyson as a motor drives engineer. In November 2014, whilst working for Dyson, Mr Pellerey was contacted by a recruiter acting for Tesla, a leading manufacturer of electric cars based in the US. Tesla made Mr Pellerey a job offer which he accepted. Tesla started the process of applying for a visa for Mr Pellerey. In late May 2015, Dyson told Mr Pellerey about Sir James Dyson's intention that the Dyson group should develop an electric car and assigned Mr Pellerey to this new project (Project E) which was to be kept confidential. When, in June 2015, Mr Pellerey received a job offer with Tesla based in Europe, which avoided problems with his US visa application, he handed in his notice to Dyson.

Dyson commenced legal proceedings seeking injunctions (i) to enforce a 12-month non-compete covenant, (ii) to cancel out a springboard resulting from Mr Pellerey's breach of a notification clause in his contract, and (iii) to restrain misuse of confidential information.

The case is notable for three things.

A four-stage approach to the enforcement of restrictive covenants

First, Snowden J identifies a four-stage approach to a claim to enforce a restrictive covenant (building on Cox J's three-stage process described in *TFS v Morgan*). The four stages are (para 57):

- identifying what the covenant means as a matter of construction
- ascertaining whether the covenant is no wider than is reasonably necessary for the protection of the employer's legitimate interests
- determining whether the proposed new employment would infringe the covenant
- determining whether to enforce the covenant as a matter of discretion in light of all the circumstances

This is a helpful structure that is likely to be adopted in future cases.

Springboard injunction for breach of a notification clause

Second, the judge considers the enforceability of a notification clause by which Mr Pellerey agreed that if any person approached him in connection with offering him employment which is or potentially may be in competition with Dyson then he would immediately inform Dyson of that approach. Mr Pellerey failed to comply with this clause. The judge held that if Mr Pellerey had told Dyson at the outset that he had accepted a conditional job offer with Tesla and was waiting for visa clearance, he would not have become involved with Project E and would not have gained access to Dyson confidential information about Project E. Dyson sought, in the alternative to enforcing the non-compete covenant, an injunction to restrain Mr Pellerey from working for Tesla for 12 months in order to remove the springboard gained by this breach. The judge held that:

- the notification clause was not a restraint of trade in that it did not limit the employee's ability to take a job
- even if it were a restraint of trade, it was reasonable since it operated as an adjunct to a restrictive covenant – it was significant here that the clause was limited to a requirement to notify Dyson of an approach from a competitor, rather than being a blanket requirement to notify Dyson of all approaches from potential new employers

- a springboard injunction was appropriate given that Mr Pellerey's breach of the notification clause meant that he learned of confidential information concerning Project E that he would not have discovered had he told Dyson of his job offer from Tesla

The judge stated the principle as follows (para 157): Once it is established that an employee has obtained access to confidential information by reason of a breach of an obligation that he owed his employer, if there is a continuing risk of future injury to the employer from unauthorized disclosure of that information, then as between the innocent employer and the wrongdoing employee, it might well be just and appropriate to grant an injunction designed to eliminate that risk, especially if the payment of damages could not fairly compensate the employer for any loss.

Injunction is the ordinary remedy to enforce a restrictive covenant

Third, the court's approach, at trial (as opposed to on an application for interim relief), to the exercise of discretion to grant an injunction to enforce a covenant, has been the subject of some controversy - partly as a result of a 2014 decision of the Supreme Court in *Lawrence v Fen Tigers*. This was reviewed by the Court of Appeal in *Dyson*, at a time when the case was simply referred to as *D v P* because of the confidentiality of Dyson's plans to build an electric car, which have since become public.

The CA held:

- the starting point in considering a claim by an employer to enforce an employee's negative covenant was that the ordinary remedy was an injunction
- however, since an injunction was a discretionary remedy, it would not be granted as a matter of course and might be refused where it would be so prejudicial or harmful to an employee that it would be unconscionable for the employer to be given injunctive relief and where the employer would suffer no damage if there were no enforcement
- every case turned on its own facts, and the burden of showing why an injunction should not be granted was on the employee
- where the damage potentially sufferable by an employer by a breach of the restraint would be unquantifiable, damages were unlikely to be an adequate substitute for an injunction.

Key

Non-compete clauses: call for evidence

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/525293/bis-16-270-non-compete-clause-call-for-evidence.pdf

ELA Working party response to call for evidence on non-compete clauses

https://www.elaweb.org.uk/sites/default/files/docs/ELA%20Response_Non-Compete%20Call%20for%20Evidence%20response_19Jul16.pdf

Good Work: a response to the Taylor Review of Modern Working Practices

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/679767/180206_BEIS_Good_Work_Report_Accessible_A4_.pdf

Dyson Technology Ltd v Pellerey [2015] EWHC 3000 (Ch):

<http://www.bailii.org/ew/cases/EWHC/Ch/2015/3000.html>

TFS Derivatives Ltd v Morgan [2004] EWHC 3181 (QB), [2005] IRLR 246:
<http://www.bailii.org/ew/cases/EWHC/QB/2004/3181.html>

Lawrence v Fen Tigers Ltd [2014] UKSC 13, [2014] 1 AC 822:
<http://www.bailii.org/uk/cases/UKSC/2014/13.html>

D v P [2016] EWCA Civ 87, [2016] ICR 688:
<http://www.bailii.org/ew/cases/EWCA/Civ/2016/87.html>