

**EMPLOYEE COMPETITION:  
COVENANTS, CONFIDENTIALITY, AND  
GARDEN LEAVE**

**MARCH 2007 UPDATE**

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## **INTRODUCTION**

1. This annual paper has been completely rewritten to coincide with the publication of *Employee Competition: Covenants, Confidentiality, and Garden Leave*.<sup>1</sup> This new book examines the law and practice relevant to protecting the business against unlawful competition by employees, directors, partners and others.
2. *Employee Competition* states the law as at February 2007. This paper considers developments in this area since March 2006.

## **PREPARING FOR FUTURE COMPETITION**

3. What can an employee legitimately do to prepare for future competition whilst remaining in his current employment? This question has been considered in a number of cases over the years, some of the more important of which include: *Balston Ltd v Headline Filters Ltd* [1990] FSR 385 (Falconer J), *Lancashire Fires Ltd v S A Lyons & Co Ltd* [1997] IRLR 113 (CA), *CMS Dolphin v Simonet* [2001] 2 BCLC 84 (Lawrence Collins J), *British Midland Tool Ltd v Midland International Tooling Ltd* [2003] 2 BCLC 523 (Hart J), and *Item Software (UK) Ltd v Fassih* [2005] ICR 450, [2004] IRLR 928 (CA).
4. The question involves consideration of a number of difficult issues including:
  - what does an employee's contractual duty of good faith entail?
  - when does an employee owe fiduciary duties?
  - how do fiduciary duties differ from the contractual duty of good faith?
  - how is the line to be drawn between permissible preparatory acts for future competition and impermissible competitive acts?
5. The first three of these issues were comprehensively considered by Elias J in *Nottingham University v Fishel* [2000] ICR 1462, [2000] IRLR 471. All of these

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<sup>1</sup> Goulding (ed), published in March 2007 by Oxford University Press. More details can be found at [www.blackstonechambers.com](http://www.blackstonechambers.com)

issues have recently been the subject of detailed examination in two recent cases: *Shepherds Investments Ltd v Walters* [2006] EWHC 836 (Ch), [2007] IRLR 110 (Etherton J), and *Helmet Integrated Systems Ltd v Tunnard* [2006] EWCA Civ 1735, [2007] IRLR 126 (CA). These recent cases demonstrate, in the words of the editor of the IRLR, “that this has become a fluid area of the law”.

**Shepherds Investments Ltd v Walters [2006] EWHC 836 (Ch), [2007] IRLR 110**

6. This decision of Etherton J followed the trial of an action brought against three former employees and directors. They were held to have acted in breach of their fiduciary duties and duty of fidelity in setting up a competing business. The claimants failed to establish that they had suffered loss which had been caused by these breaches but they were entitled to an account of profits made by the defendants from their breach of fiduciary duties.

**The facts**

7. The Shepherds group provided an investment opportunity in traded life policies (TLPs) through the purchase of interests in a number of different life policies which had been acquired (fractionalised policies).
8. There were three individual defendants:
  - Walters was finance director of one of the Shepherds companies (Financial) from 5 November 2001 until 7 May 2004;
  - Hindle was investment director of Financial from 2 September 2002 until 10 October 2003;
  - Simmons was an employee of another Shepherds company (Investments) from 29 May 2002. The claimants alleged that Simmons was a de facto director of Investments (although never formally appointed a director). The date of termination of his employment was disputed (it was either late September or early October 2003).

9. In the first half of 2003, the Shepherds group began to consider investing in whole life policies and produced a report into the TLP market (the Costello report). Thereafter, the individual defendants took a number of steps leading to the establishment of a competing business. These included the following:

- By early May 2003, the individual defendants had begun to discuss between themselves the idea that they might establish for their own benefit a new investment fund which would invest in whole life policies.
- On 13 July, they produced a draft business plan for their proposed new business. It identified themselves as the team behind the new business, Barings as the possible administrator, and Close as possible custodian and banker.
- By 13 July, they had prepared financial predictions for their proposed new business for its first three years of operation, including a cash flow summary.
- On 12 August, Walters contacted Cayman Islands attorneys (Soloman Harris) about the proposed new business.
- On 13 August, Walters confirmed to Soloman Harris that, for tax reasons, Simmons would be their client (Simmons was living outside the UK).
- On 15 August, Soloman Harris sent Simmons information about the Cayman Islands' regulatory regime relevant to the proposal for the new business.
- By letter dated 19 August, Soloman Harris confirmed to Simmons that it would accept instructions from him for the new business.
- On 26 August, Soloman Harris approached Ernst & Young to see if they would act as auditors.

- On 29 August, Soloman Harris sent Simmons a draft offering memorandum.
  - Between then and early October, successive drafts were prepared of the offering memorandum, an escrow agreement with Close, an administration agreement with Barings, a custodian agreement with Close and Barings, an investment advisory agreement, and the memorandum and articles of association of new companies. They were circulated for consideration of the individual defendants.
  - Simmons and Hindle resigned as directors and employees, their employment terminating with effect from 10 October 2003.
  - The companies for the new business were incorporated on 10 October 2003.
  - On 14 October, the final draft of the offering memorandum had been prepared.
  - On 28 November, the custodian agreement, escrow agreement and administration agreement were executed.
  - There was a special launch offer for investment in the new business from 30 November.
  - In January 2004 printed promotional literature for the new business was ordered and received.
  - In February the first agreements for supply of whole life policies for the new business were put in place.
  - In May 2004, Walters ceased to be an employee and director of Financial.
  - In June 2004, the first purchase was completed of a whole life policy for the new business.
10. Proceedings were commenced against the individual defendants and their two new companies on 17 August 2004.

### The decision of Etherton J

11. The judge considered four legal issues relevant to liability before turning to remedies.

#### *Did Simmons owe fiduciary duties?*

12. Etherton J held that Simmons was a de facto director of Shepherds Investments even though not formally appointed as such. He cited with approval a statement of Millett J in *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180:

“A de facto director is a person who assumes to act as a director. He is held out as a director by the company, and claims and purports to be a director, although never actually or validly appointed as such. To establish that a person was a de facto director of a company it is necessary to plead and prove that he undertook functions in relation to the company which could properly be discharged only by a director. It is not sufficient to show that he was concerned in the management of the company’s affairs or undertook tasks in relation to its business which can properly be performed by a manager below board level.”

13. Etherton J relied on the fact that, from a certain date, Simmons was one of a very limited number of senior managers who was responsible for Shepherds’ TLP investment business, he described himself as sales director on business cards and in letters, he was encouraged by the managing director to hold himself out as a director, and was described as a Shepherds director in the business plan for the new business.

#### *Was there a breach of duty in setting up a competing business?*

14. It was common ground that:
  - there is implied in every contract of employment an obligation to serve the employer with “good faith and fidelity”: *Robb v Green* [1895] 2 QB 315, 320 (AL Smith LJ);
  - a director is under a fundamental duty to act in what he in good faith considers to be the best interests of the company: *Item Software (UK) Ltd v Fassihi* [2005] ICR 450, [2004] IRLR 928 at [41]-[43] (Arden LJ).

15. The claimants relied on the reasoning and decision of Hart J in *British Midland Tool Ltd v Midland International Tooling Ltd* [2003] 2 BCLC 523 who described the fundamental duty of a director of a company as to “do his best to promote its business and to act with complete good faith towards it” ([81]). He also said ([89]):  
  
“A director who wishes to engage in a competing business and not disclose his intentions to the company ought, in my judgment, to resign his office as soon as his intention has been irrevocably formed and he has launched himself in the actual taking of preparatory steps.”
16. The defendants referred to Falconer J’s approach in *Balston Ltd v Headline Filters Ltd* [1990] FSR 385. Having considered the no conflict principle (namely, “that a man must not be allowed to put himself in a position in which his fiduciary duty and his interests conflict”), Falconer J said (p412):  
  
“In my judgment an intention by a director of a company to set up business in competition with the company after his directorship has ceased is not to be regarded as a conflicting interest within the context of the principle, having regard to the rules of public policy as to restraint of trade, nor is the taking of any preliminary steps to investigate or forward that intention so long as there is no actual competitive activity, such as, for instance, competitive tendering or actual trading, while he remains a director.”
17. Etherton J considered that both the decision and reasoning of Hart J in *British Midland Tool* were correct and, in so far as there is any conflict between them and the decision and reasoning of Falconer J in *Balston*, the approach of Hart J is to be preferred ([105]).
18. In Etherton J’s judgment, it was plain that the necessary starting point of the analysis is that it is the fiduciary duty of a director to act in good faith in the best interests of the company, that is to say to do his best to promote its interests and to act with complete good faith towards it, and not to place himself in a position in which his own interests conflict with those of the company. It is difficult to see, he added, any legitimate basis for “trumping” of those duties by rules of public policy as to restraint of trade as suggested by Falconer J in *Balston* ([106]-[107]).

19. He continued ([108]) that what the cases show is that the precise point at which preparations for the establishment of a competing business by a director become unlawful will turn on the actual facts of any particular case.

“In each case, the touchstone for what, on the one hand, is permissible, and what, on the other hand, is impermissible unless consent is obtained from the company or employer after full disclosure, is what, in the case of a director, will be in breach of the fiduciary duties to which I have referred or, in the case of an employee, will be in breach of the obligation of fidelity.”

20. Having approved the reasoning of Hart J in *British Midland Tool*, Etherton J then appeared to cast some doubt on a central part of Hart J’s reasoning ([108]):

“...Hart J may have been too prescriptive in saying, at paragraph [89] of his judgment, that the director must resign once he has irrevocably formed the intention to engage in the future in a competing business and, without disclosing his intentions to the company, takes any preparatory steps.”

21. He added, however, that on the facts of *British Midland Tool*, Hart J was plainly justified in concluding, in paragraph [90] of his judgment, that the preparatory steps had gone beyond what was consistent with the directors’ fiduciary duty in circumstances where the directors were aware that a determined attempt was being made by a potential competitor to poach the company’s workforce and they did nothing to discourage, and at worst actively promoted, the success of that process, whereas their duty to the company required them to take active steps to thwart the process ([108]).

22. On the facts before him, Etherton J held that by 12 August 2003, when Walters was in contact with Solomon Harris, but not before, all the individual defendants had formed the irrevocable intention to launch the new business. From that date, the individual defendants acted in such a manner as to bring about a plain conflict between their personal interests, on the one hand, and the best interests of the Shepherds group, on the other.

23. Further, each of the individual defendants was obliged, by 12 August 2003 at the latest, to disclose to Financial or Investments, as the case may be, the actual and threatened activity of the others to set up the competing business. If and so far as necessary, like Hart J in *British Midland Tool*,

Etherton J would distinguish *Balston* on the facts on the ground that the intention to compete in *Balston* does not appear to have been formed in that case prior to the resignation of the second defendant as director ([128]).

24. Following Arden LJ in *Item Software*, Etherton J held that there is no separate and independent duty of disclosure ([132]):

“In the context of the director’s own acts to promote a competing business, the breach of fiduciary duty is to carry out the impermissible acts of promotion without first disclosing the intention to do them and obtaining permission to do so. There is a breach because the director’s conflict between his personal interest and his duty to the company has not been authorised after full disclosure to, and informed consent by, the company. In the case of the acts of his fellow directors in promoting a rival business, the breach of fiduciary duty of the director is failing to disclose matters which are of relevance and concern to the company and which, if acting in good faith in the best interests of the company, the director would disclose. Those are straightforward applications of ordinary principles of equity concerning fiduciary duties.”

*Diversion of a maturing business opportunity*

25. The claimants further relied upon the principle that a fiduciary may not retain a profit which he makes from the use of property subject to the fiduciary relationship or which he otherwise makes by reason of his fiduciary position, and that, by analogy, a director who exploits after his resignation a maturing business opportunity of the company is to be treated as appropriating for himself property of the company in relation to which he had fiduciary duties. He is, accordingly, just as accountable as a trustee who retires without properly accounting for the trust property. In the case of the director, he becomes a constructive trustee of the fruits of his abuse of the company’s property, which he has acquired in circumstances where he knowingly had a conflict of interest and exploited it by resigning from the company. Reliance was placed on *CMS Dolphin v Simonet* [2001] 2 BCLC 84, especially [84] and [96], as authority for these propositions.
26. Etherton J held that the *Dolphin* principle applied to the resignations of Simmons and Hindle to enable them to establish and promote the business of investing in whole life policies. Such a business opportunity was under consideration by the Shepherds group during 2003 and no final and firm

decision had been taken against the exploitation of such a business by those companies prior to the resignations of Simmons and Hindle. Walters was in a different position as far as this claim was concerned and was not liable for diverting a maturing business opportunity.

*Express terms of employment contracts*

27. The claimants also alleged that Walters and Hindle were in breach of the express term of their contracts of employment prohibiting them from being “at any time, without the written consent of the company,...directly engaged, concerned or interested in or connected with any other company, business or concern”.
28. Those words seemed to Etherton J to be directed at a business enterprise which, if not in full operation, had nevertheless reached a stage at which it was conducting some kind of business activity ([140]). In so stating, he distinguished *Ward Evans Financial Services Ltd v Fox* [2002] IRLR 120, on the ground that the wording there not to “hold any material interest” in any company which “impairs or might reasonably be thought by the company to impair his ability to act at all times in the best interests of the company” was much wider than the contractual term in the present case ([137]-[139]).
29. Etherton J upheld this claim against Walters who, unlike the defendant in *Saatchi & Saatchi Co plc v Saatchi* (13 February 1995) was assisting the activities of the new companies whilst still employed by the Shepherds group.

*Damages*

30. The claimants sought damages for the loss said to have been caused to it as a result of the loss of business allegedly suffered by them in consequence of the establishment of the new companies at an earlier period of time than would have been the case had the individual defendants not been in breach of duty (cf *Coleman Taymar Ltd v Oakes* [2001] 2 BCLC 749).
31. Etherton J found the period of unlawful activity to be from 12 August 2003 until the respective resignations of the individual defendants. The critical

period was from 12 August to 10 October 2003. However, he rejected this claim to damages. In so doing, he stated ([150]):

“It is critical that, in order to establish a claim for damages, the loss allegedly suffered by Financial and Investments is linked to the individual defendants’ unlawful acts rather than the mere fact of loss of senior management personnel and sales people. The individual defendants were entitled to resign. In general, there is no legal impediment to a number of employees deciding in concert to leave their employer and set themselves up in competition.”

*Account of profits*

32. In view of the judge’s finding that the individual defendants committed breaches of their fiduciary duties, the claimants were entitled to an account of the profits made by them in consequence of their unlawful conduct in promoting after 12 August 2003 the establishment of the new business: see *CMS Dolphin* ([163]). This account was to be taken following the trial and is not the subject of further discussion in the judgment.

**Helmet Integrated Systems Ltd v Tunnard [2006] EWCA Civ 1735, [2007] IRLR 126**

33. A later decision of the Court of Appeal suggests a more generous approach to preparing for future competition may be adopted where an employee acts on his own and consistently with his express contractual obligations.

The facts

34. Helmet Integrated Systems Ltd (HISL) produces and sells protective equipment. It successfully marketed the F600 helmet after 1998, its largest customer being the London Fire Brigade.
35. Tunnard was a senior salesman for HISL. In 2001 he hit upon an idea for a new helmet, primarily, but not exclusively, for firefighters. He believed that his employers were not interested in developing a new helmet, particularly on the European market, where he perceived there to be a gap.
36. Between September 2001 and 28 February 2002, Tunnard took certain steps to advance his idea:

- He applied for and obtained (on 7 November) a SMART award, to provide some DTI funding to advance his project. In his application, he identified Lion, the UK subsidiary of a rival US company engaged in the manufacture and supply of safety equipment and clothing, as his preferred option for a partnership agreement; he identified Modular Helmet Systems Ltd (MHSL), a company he incorporated after leaving HISL, as the business he would use to develop the idea; and, importantly, he identified HISL as a competitor.
  - On 19 November, he instructed product designers, AME, to proceed with the design of a new helmet and for that purpose handed over a number of competitors' helmets including HISL's F600.
  - In November and December, Tunnard met AME and, on 20 December, AME showed him initial concept drawings with a product realisation plan, which it had prepared.
  - On 1 February, Tunnard tendered his resignation. He was asked to work out his notice which he did until he left on 28 February.
  - In February, Tunnard considered AME's concept with a friend (Tyrrell), a consultant to Lion (the competitor). On 12 February, Tyrrell sent some of AME's drawings, under confidential cover, to Lion's corporate counsel.
37. After his departure from HISL, Tunnard took the following steps:
- He incorporated MHSL on 30 April 2002, two months after leaving HISL.
  - Shortly thereafter, Lion took up a majority shareholding in the new company, MHSL.
38. The judge in the Patents County Court rejected HISL's claims for infringement of design right (which was not appealed), breach of duty of fidelity and fiduciary duties (a decision which was appealed). In doing so, he stressed ([16]):

- there was no misuse of confidential information;
- there was no breach of any restrictive covenant;
- no other HISL employee was involved;
- Tunnard carried out his activities in his own time without use of any HISL property;
- there was no commercial agreement or arrangement made before Tunnard left and no actual competition;
- Tunnard was neither a director nor an employee of similar rank, he was a middle-ranking senior salesman.

The decision of the Court of Appeal

39. The Court of Appeal dismissed the company's appeal.

*Tunnard's duties and rights as employee*

40. Tunnard's contract provided:

"there is a duty upon the employee to act at all times with the best interests of the company in mind"

and

"no employee will be permitted to undertake any work or arrange the undertaking of any work which can be seen to affect adversely or be in competition with the company"

41. His job specification, provided at a time when Tunnard was international sales manager, stated that it was his duty

"to advise on competitor activity and pricing structures"

42. Having summarised the trite law regarding an employee's duty of fidelity, Moses LJ observed that the freedom to compete, once an employee has left, unrestrained by any enforceable covenant, carries with it a freedom to prepare for future activities, which the employee plans to undertake, once

he has left. He noted ([27]) that in *Robb v Green*, Hawkins J (the first instance judge)

“observed, in words echoed frequently thereafter, that each case would depend upon its own circumstances and there will be cases where an employee may legitimately canvass, issue circulars, have a place of business ready and hire employees. The Court of Appeal made no observation suggesting disagreement when it affirmed Hawkins J’s conclusion.”

43. Moses LJ stated that the battle between employer and former employee, who has entered into competition with his former employer, is often concerned with where the line is to be drawn between legitimate preparation for future competition and competitive activity undertaken before the employee has left. But in deciding on which side of the line the employee’s activities fall, it is important not to be beguiled into thinking that the mere fact that activities are preparatory to future competition will conclude the issue in a former employee’s favour. He cited *British Midland Tool* and *Shepherds Investments* as examples of cases where work of preparation constituted breaches of fiduciary duties and (in *Shepherds Investments*) the implied duty of fidelity. It is insufficient to cloak activities with legitimacy by describing them as preparatory ([28]-[32]).

#### *Fiduciary duties*

44. Given the difficulties of proving loss and, hence, of recovering compensatory damages, from a breach of the contractual duty of good faith, the appeal turned on HISL’s ability to establish a breach of fiduciary duties.
45. Citing Elias J’s analysis in *University of Nottingham v Fishel* [2000] ICR 1462, [2000] IRLR 471 as the clearest analysis of the distinction between the employee’s duty of good faith and a fiduciary’s duty of loyalty, Moses LJ stated that ([36]):

“The distinguishing mark of the obligation of a fiduciary, in the context of employment, is not merely that the employee owes a duty of loyalty but of single-minded or exclusive loyalty.”

46. Moses LJ accepted that ([42]-[45]):

- if Tunnard had learned that a competitor of HISL proposed to develop a helmet which was a rival to the F600 produced by HISL and was in the process of preparing a preliminary concept of such a helmet, he was under an obligation to report that information (it would be “competitor activity” within the meaning of the job specification);
- a “competitor” within the meaning of the job specification might include a third party which had never previously competed but proposed to do so;
- Tunnard would be under an obligation to deploy such information exclusively in the interests of his employer;
- if Tunnard used information about such activity either for the benefit of someone other than HISL or for his own benefit he would be in breach of a fiduciary obligation. This is because HISL would have no control over how Tunnard deployed what he learned as a salesman, and would be dependent on him to pass on the information. Such vulnerability was what Lord Millett in *Equity's Place in the Law of Commerce* (1998) 114 LQR 214, 219 described as a “defining characteristic” of a fiduciary relationship.

47. But, according to Moses LJ, HISL’s argument broke down at the conclusion sought to be drawn from the premise. It did not follow from the above that Tunnard was under any obligation, be it fiduciary or otherwise, to inform HISL of his own activities or such activities undertaken on his own behalf. There were two fundamental reasons why this was so. First, the words of the job specification did not restrict Tunnard’s freedom to prepare for competition on leaving. Secondly, he was under no relevant fiduciary obligation to HISL ([46]-[47]).

48. Moses LJ (with whom Lloyd and May LJJs agreed) concluded ([51]):

“The true reason, as I see it, why Mr Tunnard's activities did not amount to a breach of any obligation to HISL lies in the fact that HISL had not restricted the freedom which Mr Tunnard had to prepare for future competition on his departure.”

## INTRODUCING RESTRICTIVE COVENANTS

49. One of the most effective means of protecting the business from competition is to ensure that employees are bound by enforceable post-termination restrictive covenants. But what is the position where an employer comes under a competitive threat and seeks to introduce restrictive covenants for the first time (or to amend existing covenants)? Can the employer insist on an employee accepting the covenant in such circumstances? If the employee refuses and is dismissed, is the dismissal fair or unfair?
50. These questions arose in the *Willow Oak* case discussed below.

**Willow Oak Developments Ltd (trading as Windsor Recruitment) v Silverwood**  
[2006] ICR 55, [2006] IRLR 28 (EAT); [2006] EWCA Civ 660, [2006] ICR 1552, [2006] IRLR 607 (CA)

### The facts

51. The employer, Windsor Recruitment, specialised in the supply of agency workers for health services. It had 10 branches nationwide, and employed about 50 consultants. The claimants worked at the Leeds branch as “consultants” in the health care sector, responsible for recruitment and placing of staff in health care posts, including in the NHS.
52. In 2003 and 2004 two senior employees of Windsor Recruitment, one in Birmingham and one in Bristol, left and set up rival businesses. They took with them a significant number of other employees, with the loss to Windsor of much client and candidate information, leading to a reduction in Windsor’s business. Further poaching was attempted by the rival businesses leading Windsor to decide that it had to take action to protect itself against further attacks.
53. Windsor decided that all staff would be asked to sign detailed restrictive covenants, and that any who refused to do so would be dismissed. On 19 May 2004, an operations director (Watson) attended at the Leeds office without prior warning and (in his own phrase) “handed copies of the covenants to each employee as one might deal out a pack of cards. He told

each employee that they had 30 minutes in which to consider whether to sign" ([10]). He was generally offensive in his dealings with the employees, although he did agree to a request for more time to consider the covenants. One employee was told that if she did not sign, the company might have to "force the issue", though dismissal itself was not threatened. By the deadline, only 7 of 26 consultants had signed the covenants. The remainder were dismissed. They were offered "alternative employment", although the employment tribunal found the offer to be confusing.

### The decision

54. The employment tribunal upheld the claimants' complaints of unfair dismissal. It decided that the covenants were so unreasonable that dismissal for refusing to agree to them could not amount to some other substantial reason which could potentially justify the dismissal within the meaning of section 98(1) of the Employment Rights Act 1996; alternatively, the dismissals were procedurally unfair. In adopting this approach, the tribunal followed the reasoning of the EAT (Rimer J presiding) in *Forshaw v Archcraft Ltd (Note)* [2006] ICR 70.
55. The EAT in this case disagreed with that approach, which disqualifies any unreasonable covenant from counting as a reason that comes within the terms of s98(1) (SOSR). The Court of Appeal agreed with the EAT. The clue to this issue, according to Buxton LJ, is that the question asked by s98(1) is whether the employer's reason is *of a kind* such as to justify the dismissal ([15]). Buxton LJ explained:

"But if, as in our case, the category into which the reason falls, an employee's refusal to accept covenants proposed by the employer for the protection of his legitimate interests, is one that can in law form a ground for dismissal, then it is necessary to proceed to the second stage of considering whether the employer has, under section 98(4)(a), acted reasonably or unreasonably in treating that reason as a sufficient reason for dismissing the employee."
56. At the second stage, the tribunal's finding that the dismissal was unfair could not be impugned. It found that the unreasonableness of the way in which the covenants were introduced on 19 May set the tone for all the

future discussions; and, most importantly, it also found that there had been no warning that failure to agree to the new terms would or might result in dismissal. In the judgment of Buxton LJ (with whom Neuberger LJ and Sir Martin Nourse agreed) “That last fact alone justified, indeed made inevitable, a finding that the dismissals had been procedurally unfair” ([29]).

### **ENFORCING RESTRICTIVE COVENANTS**

57. The most draconian form of restrictive covenant is one which prohibits competition altogether for a period of time. Cox J recently enforced a non-compete covenant following a trial in *TFS Derivatives v Morgan* [2005] IRLR 246. The Court of Appeal has now followed suit.

#### **Thomas v Farr Plc [2007] EWCA Civ 118**

58. In *Thomas v Farr Plc*, the Court of Appeal enforced a 12-month non-compete covenant against the former Managing Director of a firm of insurance brokers. The decision contains useful guidance on the approach to be adopted when assessing whether the protection of confidential information provides a sufficient legitimate interest to justify an onerous restraint of this nature.

#### **The facts**

59. Farr is an insurance broker which specialises in providing services for providers of social housing, in particular housing associations. Thomas had been employed in the insurance industry for 10 years before joining Farr. He progressed up the ladder at Farr serving as account director, director, operations director and, ultimately, managing director. In that position, his salary was £176,900 and he had the benefit of a bonus scheme.
60. The insurance market in social housing is a small and specialist market. There are in all about 1500 housing associations, of whom 350 were Farr’s clients. About 20% of those clients were responsible for 80% of Farr’s income.

61. Thomas resigned because he was unhappy about the consequences of a proposed restructure on his employment. He accepted an offer of employment from a company which intended to compete with Farr. Farr had about one third of the market share of housing association work in England and Wales. Thomas' proposed employer was a new entrant to the market.

#### The non-compete covenant

62. Thomas' proposed employment was in breach of a non-compete covenant in his employment contract, if that covenant was enforceable.
63. In essence, the covenant provided that Thomas would not, for 12 months from the date of termination of his employment, be engaged in any business which is the same as or in competition with the Business anywhere in the Restricted Territory.
64. For this purpose, the "Business" meant the business of providing property and buildings insurance and risk management and training, carried on by Farr as at the termination date and during the 12 months prior thereto. The "Restricted Territory" meant any geographic area in which any company in the Group conducts the Business and for which Thomas was responsible or to which he rendered services in the 12 months preceding the termination date.
65. There were also non-solicitation and confidentiality covenants in the employment contract.

#### The proceedings

66. Unusually in a dispute about the enforceability of a restrictive covenant, it was the employee who commenced proceedings. Thomas claimed against Farr damages for breach of contract, a declaration that he had been constructively dismissed, and a declaration that the non-compete covenant in his contract was an unreasonable restraint of trade and unenforceable.

67. The issue as to unreasonable restraint of trade was tried as a preliminary issue. Farr's case was that the clause was necessary to safeguard it against the risk that on taking up employment with a competitor, Thomas would misuse information confidential to Farr, wittingly or unwittingly, to Farr's detriment and the competitor's advantage. Thomas accepted in evidence that he had received information which he would regard as confidential, but he denied that he had any information which would be of any continuing interest or relevance to a competitor.

#### The decision of the judge

68. The judge, Ramsey J, found that Thomas was privy to all major and strategic operational decisions made by Farr, and in his role as Operations and later Managing Director he had overall responsibility for all of Farr's existing business. Whilst he would not recall every detail, he had and would continue to have a recollection of major matters to a considerable level of detail.

69. Having reviewed a number of the leading authorities, the judge found that Thomas had confidential information, which Farr had a legitimate interest to protect, within the following categories:

- business development through the use of a captive insurer;
- exploitation of new areas of business within social housing;
- exploitation of new geographical markets;
- business development through acquisition of other businesses; and
- pricing and financial information relating to clients and insurers.

70. The judge held that the clause was enforceable. He concluded that a clause which precluded Thomas from operating as an insurance broker in the social housing sector in England and Wales, but which permitted him to operate in all other sectors of the insurance industry, was a reasonable

limitation to impose in all the circumstances, and that a period of 12 months was also a reasonable period.

The decision of the Court of Appeal

71. Thomas appealed to the Court of Appeal, which dismissed his appeal. There were four grounds of appeal.

72. First, it was argued that Farr had failed to adduce sufficiently clear and cogent evidence to establish that Thomas ever had, or was likely to have, any information which Farr could require to be treated as confidential after the termination of Thomas' employment. Toulson LJ gave a timely and striking reminder that the enforceability of a covenant in restraint of trade is to be judged at the time the contract is entered into. He explained that in order to establish that the inclusion of a non-compete clause in an employment contract was reasonably necessary for the protection of the employer's interest in confidential information, the first matter which the employer obviously needs to establish is that ([41])

"at the time of the contract the nature of the proposed employment was such as would expose the employee to information of the kind capable of protection beyond the term of the contracts (ie. trade secrets or other information of equivalent confidentiality."

73. The degree of the particularity of the evidence required to establish that matter must inevitably depend on the facts of the case. Citing Aldous LJ in *Scully UK Ltd v Lee* [1998] IRLR 263 at [23], the judge considered that sufficient detail must be given to enable it to be decided whether there was confidential information which the employer was entitled to protect but no more was necessary.

74. Provided that the employer overcomes that hurdle, it is no argument against a restrictive covenant that it may be very difficult for either the employer or the employee to know where exactly the line may lie between information which remains confidential after the end of the employment and the information which does not. According to Toulson LJ ([42]), with whom Scott Baker and Chadwick LJ agreed, the fact that the distinction can be very hard to draw may support the reasonableness of a non-compete

covenant, relying on the well-known observation of Lord Denning MR in *Littlewoods Organisation v Harris* [1977] 1 WLR 1472 at 1479 and also of Waller LJ in *Turner v Commonwealth and British Minerals Ltd* [2000] IRLR 114 at [18]. It is because there may be serious difficulties in identifying precisely what is or what is not confidential information that a non-compete covenant may be the most satisfactory form of restraint, provided that it is reasonable in time and space.

75. There was ample evidence to support the judge's conclusion that in the nature of things Thomas' appointment as Farr's managing director exposed him to information which Farr was entitled to require to be kept confidential after the termination of his employment. The clearest example was pricing and financial information.
76. Interestingly, Toulson LJ noted that if it had been the case that, as events turned out, Thomas was unable to recall any truly confidential information after leaving Farr, that could afford a reason for the court not granting an injunction in support of the non-compete clause. It would not follow that the clause was unreasonably in restraint of trade at the time of his appointment ([47]).
77. The second ground of appeal was that the non-solicitation and confidentiality clauses provided adequate protection for Farr. The Court of Appeal disagreed for a number of reasons, one of which was the "self evident" practical problems of trying to police a non-solicitation clause ([48]).
78. Thirdly, it was argued for the employer on appeal that the non-compete clause was too wide in preventing Thomas from engaging in competition with Farr in any place where it had conducted business in the 12 months prior to termination. The Court of Appeal again disagreed, pointing out that the clause would not prevent Thomas from acting as an insurance broker in sectors other than social housing, nor would it prevent him from acting for insurers in that sector as long as he did not do so in a way which was in competition with Farr.

79. Finally, it was submitted that the non-compete clause ought in principle to be shorter than the non-solicitation covenant, whereas the duration of each was 12 months. The Court of Appeal failed to see the logic of that submission. Neither did it accept the more general point that Farr had failed to justify a 12-month restriction on competition. There was evidence that information, for example, about arrangements with insurers or planned business developments could often remain confidential for more than a year. In the circumstances, 12 months was reasonable.

**Allan Janes LLP v Johal [2006] EWHC 286 (Ch), [2006] ICR 742, [2006] IRLR 599**

80. Are solicitors a special case when it comes to restrictions on competition? This suggestion has surfaced periodically in the past and makes an appearance again in the first instance decision in *Allan Janes v Johal*. The case also considers the important issue of whether an employee must have had past dealings with clients with whom he is not to deal in the future.

**Facts**

81. Allan Janes LLP, the claimant, is a small firm of solicitors with offices in High Wycombe. It had 5 partners, and between 5 and 7 assistant solicitors, one of whom was Ms Johal, the defendant.

82. The firm had on its database the names of about 2,000 clients who had given instructions over the period 2002-5. In the year 2004-5, it opened files on about 750 new matters for about 650 different clients. Of these, the defendant dealt in that period with 64 as the solicitor handling the matter and a further 34 when covering for an absent colleague. There were 45 or so firms of solicitors with offices in the area.

83. The defendant qualified as a solicitor in 1989. She specialised in commercial property. She was offered a position with the claimant by a letter which stated "this is a senior position which we hope would lead to an offer to join the partnership after a suitable period of assessment on both sides."

84. A little over 5 years after joining, the defendant resigned, working out her three months' notice. During her period of notice, the defendant seriously

abused her position and breached the express and implied terms of her contract. This included working for other firms, diverting business from the claimant to the new partnership which she was to join, and taking with her a soft copy of a list of clients prepared for a marketing exercise by the claimant. In the week after her employment came to an end, the defendant began soliciting clients of the claimant for her new practice in High Wycombe.

85. There were two restrictive covenants to which the defendant was subject: an area covenant, and a non-dealing covenant.

The area covenant

86. The defendant agreed not for 12 months after termination to practise as or do the work of a solicitor within a radius of 6 miles from the claimant's office. Excluded from this restriction was work in fields in which the firm did not practise as at her termination date and work for specified types of clients.
87. The first task was to construe the wording of the covenant. The defendant argued that the clause did not restrict her, provided she had a place of practice outside the area, from doing work within the area. The judge disagreed. The words "or do the work of a solicitor" were intended to add something to the words "to practise". Doing the work of a solicitor within the area included visiting within the radius and even delivering a letter of advice either personally or by post.
88. As to reasonableness, the judge concluded that an area clause which was not limited to the clients of the firm was wider than was necessary to protect the firm's legitimate interests. Having regard to the size of the population within a radius of six miles of the firm's offices, a radial restriction would serve mainly to protect the firm from competition for the business of a very large number of commercial entities which were not, or had well and truly ceased to be, clients of the firm. The claimant was not entitled to that sort of protection.

### The non-dealing covenant

89. The defendant also agreed not for a period of one year post-termination to act as a solicitor or do the work of a solicitor for any person who shall have been a client of the firm in the previous 12 months. Curiously, this non-dealing covenant was further limited by reference to geographical area around High Wycombe.
90. The central argument of the defendant was that the non-dealing covenant was unreasonable in that it was not limited to clients with whom she had personally dealt. She pointed to the fact that she had direct dealings with only 9-10% and indirectly (by provision of holiday cover) with a further 5% of those clients for whom the firm did work in the last 12 months of her employment. In support of her argument, she relied on a number of authorities: *Office Angels Ltd v Rainer-Thomas* [1991] IRLR 214, per Sir Christopher Slade at [45]; *Wallace Bogan v Cove* [1997] IRLR 453, per Potter LJ at [19]; *Dentmaster (UK) Ltd v Kent* [1997] IRLR 636, per Waite LJ at [17]; *Marley Tile Co Ltd v Johnson* [1982] IRLR 75, at [14]-[17]; *Austin Knight (UK) Ltd v Hinds* [1994] FSR 52,58.
91. The judge (Bernard Livesey QC) recognised that the fact that the restriction was not limited to those clients with whom the defendant had personal contact in the period of one year prior to termination was an important consideration which significantly widened the restriction; attempts to justify it must therefore be carefully considered. After due consideration he concluded that the width of the clause was not fatal to its reasonableness: [62].
92. According to the judge, the emphasis on the statistics of personal client dealings in the last year of employment was superficially attractive but fundamentally misconceived for the important reason that it neglects the importance of judging the reasonableness of the restriction as at the date when the contract was made and not when it came to an end.
93. It was within the contemplation of the parties when the contract was made that, in pursuance of the objective of developing the relationship of the

claimant with the defendant to the doors of partnership, she would be introduced widely to a large proportion of the firm's key clients. The judge added at [63]:

"Her very presence as a respected member of the firm in which the partners had trust endowed her with a special status on which she could rely vis-à-vis even those clients with whom she had no prior contact."

Solicitors – a special case?

94. The judge firmly decided that solicitors are not a special case in the sense of being immune from the principles in this branch of the law applicable generally to employees, relying on the decision of the Court of Appeal in *Wallace Bogan v Cove* [1997] IRLR 453, especially per Leggatt LJ at [12].

**Beckett Investment Management Group Ltd & Ors v Hall & Ors [2007] EWHC 241 (QB)**

95. Two discrete points of interpretation were considered in this recent decision of Judge Richard Seymour QC which may afford some assistance in future case.

The meaning of "to deal"

96. Where an employee agreed not "to deal" with a client for a period of time after termination, what does this mean? In the context of the *Beckett* case, the word deal, or its past participle "dealt", meant "do business". It did not encompass any interaction at all with someone. While the word could have this wider meaning, it was plain from the context that that was not the intention: [87].

The meaning of "client"

97. The meaning of "client" was also in dispute in the same case. The judge recognised that the noun "client" in English is capable of a number of meanings. In his judgment, in this context, to be a "client" is not a status, but a description of a contractual relationship, past or present. Thus, a "client" of a professional person describes someone for whom for the time being the professional person is in a contractual relationship under which he is to

provide some service. Someone for whom the professional person has provided a service in the past, but is not doing so currently, is not a “client”: he has been a “client” in the past: [90].

## **BONUSES**

98. An increasing feature of employment litigation in recent years has been bonus claims by employees. These can take a number of guises: High Court claims for a “rational” bonus, or forming part of other tribunal claims (such as whistleblowing).
99. It is now well-settled that where an employee is a member of a discretionary bonus scheme, he is entitled to a bona fide and rational exercise by the employer of the discretion as to whether or not to pay him a bonus and in what sum: *Clark v Nomura International plc* [2000] IRLR 766 (Burton J); *Horkulak v Cantor Fitzgerald* [2004] IRLR 942 (CA).
100. Two recent cases indicate new directions which these cases are taking.

### **Takacs v Barclays Services Jersey Ltd [2006] IRLR 877**

101. In this case, a Queen’s Bench Division Master (Master Fontaine) declined to strike out an employee’s claim on the ground that breaches of various implied terms were considered by the Master to be arguable.

#### **The facts**

102. The claimant was a banker. He joined the defendant in November 2003. He was dismissed with notice served in November 2004 with effect from a date in December 2004.
103. An express term of his employment provided for payment to him of a minimum bonus and an additional bonus if he achieved his sales target. It was also provided that the making of any bonus award was “subject to you being in the company’s employment and not working out a period of notice at the time that award is due.”

104. The claimant brought a claim for his 2004 bonus notwithstanding that he was not employed on bonus payment date. In doing so, he alleged breach of implied terms.

#### The implied terms

105. The claimant relied on three implied terms.

#### *Implied term of trust and confidence*

106. The claimant alleged that there was a breach of the implied term of trust and confidence in that his position was undermined following a management restructuring which forced him out before he could close a deal that would have enabled him to meet his sales target which was the precondition for the additional bonus payment.
107. The claimant argued that this implied term could not override the express terms of the contract, including the bank's express right to terminate the claimant's employment on one month's notice, relying on the decision of the Privy Council in *Reda v Flag* [2002] IRLR 747.
108. The Master did not consider that the implied term of trust and confidence asserted by the claimant contradicts or is inconsistent with the express terms of the contract. The contract provides that there may be termination for other than gross misconduct, but the claimant relies on a breach of the implied duty of trust and confidence occurring before termination, and which is entirely independent of the express terms of the contract relating to termination. *Reda v Flag* and *Johnson v Unisys* were distinguishable: [56].
109. Further, this is an area of the law which is in the process of developing and it would not be appropriate to determine the claim at a summary hearing: [58].

#### *Implied term of co-operation*

110. The claimant also contended that there was an implied term that the defendant would co-operate with the claimant in, and not prevent, the

fulfilment of the condition for the additional bonus payment, namely meeting the sales target.

111. The defendant denied the existence of this term, although it accepted that there was an implied term that neither party would unduly frustrate the efforts of the other party to the contract to perform its obligations under the contract.
112. The Master accepted that it was arguable that the defendant was in breach of the implied term of co-operation, either as formulated by the claimant or as admitted by the defendant in its more limited formulation of the term: [67]. It could not be concluded that it is inherently incredible that the defendant would not co-operate with the claimant, or frustrate his efforts to perform his obligations under the contract, so that it would not be obliged to pay the additional bonus on his reaching the sales target.

*Implied anti-avoidance term*

113. The claimant also alleged that there was a term implied in the contract that the defendant would not terminate the claimant's employment in order to avoid the obligations to make the additional bonus payment.
114. The claimant relied upon *Jenvey v Australian Broadcasting Corporation* [2002] IRLR 520, where Elias J found the implied term that, where a contract contained enhanced redundancy benefits, in the event of impending redundancy, the employer could not dismiss for another reason simply in order to avoid paying the employee his contractual entitlement to the enhanced redundancy benefit (see, also, *Aspden v Webbs Poultry* [1996] IRLR 521).
115. The Master concluded that there was a real prospect of successfully arguing that such an implied term would support, rather than be inconsistent with, the express termination provision in the contract. That this is a developing area of law was a further reason why there should be a trial, rather than a summary determination, of the issue.

**Commerzbank AG v Keen [2006] EWCA Civ 1536, [2007] IRLR 132**

116. In *Commerzbank v Keen*, the Court of Appeal decided an important point on employment contracts and the Unfair Contract Terms Act 1977 (UCTA), and also emphasised the high threshold for an employee who seeks to challenge the exercise of a bonus discretion by an employer.

The facts

117. Keen was employed by Commerzbank for less than three years, from November 2002 until he was made redundant on 10 June 2005. He was eligible to participate in the bank's discretionary bonus scheme on the following terms:

"You are eligible to participate in the [bank's] discretionary bonus scheme. The decision as to whether or not to award a bonus, the amount of any award and the timing and form of the award are at the discretion of the [bank]. Factors which may be taken into account by the [bank] in deciding whether or not to award a bonus and the amount of any bonus include

- The performance of the [bank]
- The performance of your business area
- Your individual performance and your contribution to the [bank's] performance and the performance of your business area
- The strategic objectives of the [bank]
- Whether you will be remaining in the employment of the [bank]

No bonus will be paid to you if on the date of payment of the bonus you are not employed by the [bank] or if you are under notice to leave the [bank's] employment whether such notice was given or received by you."

118. Keen was awarded bonuses of almost €3m for the years 2003 and 2004. This made him the fourth most highly paid employee of the bank's global banking operation in 2003, and the third most highly paid in 2004.

119. Keen claimed damages for breach of contract (a) by under-payment of bonuses for the years 2003 and 2004, and (b) by non-payment of a bonus for the year 2005 (he having been dismissed by bonus payment date.

120. The bank applied for summary judgment on these claims. The application was dismissed by Morison J but allowed by the Court of Appeal.

#### Under-payment of bonus

121. First, Mummery LJ held that consistent with the duty of trust and confidence, an employer ought to supply an employee with an explanation of the reasons for the exercise of a discretion in respect of additional pay. Unless there is a good reason to the contrary the explanation ought to be given by the person(s) responsible for the decision affecting additional pay: [44].

122. As for the alleged under-payment, Mummery LJ stated that there are extreme difficulties in law and in fact in the way of such a claim succeeding, based as it is solely on a challenge to the lawfulness of the exercise of a wide discretion. Keen was unable to surmount these difficulties.

123. First and foremost, the bank has a very wide contractual discretion. Mummery LJ added ([59]):

“It would require an overwhelming case to persuade the court to find that the level of a discretionary bonus payment was irrational or perverse in an area where so much must depend on the discretionary judgment of the bank in fluctuating market and labour conditions.”

124. Secondly, there was no independent evidence, expert or otherwise, lending any support to the employee’s claim of irrationality in the size of the bonus pools for the two years (which formed part of his complaint): [60].

#### Non-payment of bonus

125. The claimant argued that the term requiring him to be in the bank’s employment on bonus payment date, in order to be eligible to receive a bonus, was an unfair contract term within s.3 of UCTA and subject to the statutory requirement of reasonableness.

126. The first question was whether UCTA applies at all to a contract term for the remuneration of an employee. Section 3 of the Act “applies as between

contracting parties where one of them deals as a consumer or on the other's written standard terms of business."

127. Mummery LJ concluded that under a term for remuneration, Keen did not "deal as a consumer" with the bank. He also held that Keen did not contract on the bank's "written standard terms of business" in relation to the provision in the bonus scheme requiring him to be in the employment of the bank at the bonus payment date. The relevant business was the business of banking. The terms as to the payment of discretionary bonuses were not the standard terms of the business of banking: [101]-[104]. Jacob and Moses LJ agreed.

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