OFF THE RAILS

WHEN EMPLOYEES BOLT WITH YOUR BUSINESS?

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The easiest way for ex-employees to begin business in competition with their ex-employer is to take with them, when they leave, copies of their ex-employer's client details, such as name, address, telephone number and product history.

Throw in a copy of the ex-employer's price list, formulae and fellow employee contact numbers and the ex-employees are off to a flying start, while the ex-employer watches his business walk out the door.

And the quickest way for an unscrupulous competitor to take over a large portion of its closest competitor's business is to offer those ex-employees a handsomely paid job.

This is no small area of practice.

Looking only at disputes that reach the superior courts, in 2005 there were 30 such cases and up to July this year there were 13 cases. Most, if not all, could have been prevented with some simple legal advice years before.

There is no common law doctrine of "unfair competition" in Australia, but there is a mosaic of laws which can be used to protect employers in these circumstances. However, there is a catch. These laws are much more effective if the employer has undertaken preventative action before its secrets walk out the door.

Unprompted advice to the effect that it must prepare now if it wants full protection later is a service "on-the-ball" lawyers could be offering all their business clients.

THE LAW

Following *Faccenda Chicken Limited v Fowler* [1] (*Faccenda Chicken*), now the leading case in the UK and in this country, the murky mists surrounding protection of an employer's business information have now cleared, leaving a simpler framework on which lawyers can give initial advice to clients. The checklist is summarised as follows:

- no trade secret;
- no valid restraint of trade clause;
- no blatant, provable dishonesty;
- no protection.

Faccenda Chicken divided information into three classes:

- trade secrets;
- know-how;
- trivial information.

Trivial, well-known or pernicious information, such as tittletattle or useless information, cannot be protected.[2] Confidential information is then divided into two types, "trade secrets" and "know-how".

Trade secrets can always be protected – but the trick is answering the question, will the courts classify the information in question as a trade secret?

"Know-how" can be protected, but only if the ex-employer has taken preventative action by way of a restraint of trade

ILLUSTRATION **NIGEL BUCHANAN**

clause. Otherwise the honest (or clever) ex-employees can walk it out the door.

The bulk of information employers wish to protect from their competitors falls into the category of know-how (for example, customer lists, often price lists or even business methods or ingredients that have become part of the employee's inherent skill). Before defining know-how, describing how to protect it and noting the current developments in this ever-growing area of conflict, a short word about trade secrets.

TRADE SECRETS

Protection of trade secrets is a very large topic, but it too relies on preventative measures.

In the leading case of *Thomas Marshall (Exports) Ltd v Guinle*,[3] the court listed the matters it will look at in determining whether information was or was not sufficiently "confidential" to earn the label "trade secret".

This list, adopted many times in Australia,[4] includes:

1. the extent to which the information was known outside the business;
2. the extent to which the trade secret was known by employees and others involved in the plaintiff's business;
3. the extent of measures taken to guard the secrecy of the information;
4. the value of the information to the plaintiffs and their competitors;
5. the amount of effort expended in developing the information; and
6. the ease with which the information could be acquired or duplicated by others.

What is immediately noticeable is that 2, 3 and 6 are all matters of evidence that rely on action taken by the employer before the information was removed and during the employment of the ex-employee. So, even in the case of trade secret protection, it is often preventative action that saves or loses the day (see, for example, *Southern Cross Financial Group Pty Ltd v Rodrigues*[5] (*Southern Cross*)). It is an important field of advice. Employers need to ensure their systems and conduct codes "bespeak" confidentiality.

PROTECTION OF "KNOW-HOW"

The central premise on which the employer's protection stands is that restraint of trade clauses must be included in every employment contract where there lurks the possibility, no matter how improbable it may seem at the time of the employment, that the employee may depart with slabs of secret information in the form of the company's "know-how".

How do the courts decide what is "know-how" as distinct from what is a trade secret or trivial information? The classic definition of "know-how" was given 50 years ago in the leading case of *Printers and Finishers Ltd v Halloway (No 2)*,[6] picked up in the leading Victorian case *Ansell Rubber Co Pty Ltd v Allied Rubber Industries*[7] and still consistently referred to and updated in Australian cases such as *Consolidated Paper Industries Pty Ltd v Matthews*.[8]

The court asked the question, "can the information be regarded as a separate part of the employee's stock of knowledge which a man of ordinary honesty and intelligence would recognise to be the property of his old employer and not his own to do as he likes with".

If not, then it is theirs to take with them when they leave unless the employer has a valid restraint clause.

There are more helpful descriptions. "Know-how" is that secret information which becomes part of the employee's skill and experience, inseparable from his or her general knowledge, so that it would be impractical to say to an ex-employee in a new job – "pretend you don't know this!".[9]

The best example is the salesman's knowledge of customer lists. If the lists are highly specific[10] and detailed[11] or voluminous[12] they may be classified as trade secrets because they are not part of the ex-salesman's skill and experience and he or she would have to have taken a list or deliberately copied a list before leaving. But this is the exception.

It is far more likely that they will be classified as "know-how". Of course, any attempt by an employee to copy any information before leaving his or her employment for the purpose of using it after the termination of that employment, whether know-how, trade secret or otherwise, will be a breach of fiduciary duty and dealt with severely by the courts.

Even though the information taken is know-how and cannot be given the absolute protection of a trade secret, nevertheless the courts are not blind to the unfairness of an employer facing immediate competition with its own large body of valuable information which may have taken many years to accumulate.

In a de facto common law action for "unfair competition" the courts impose a trade off. They give substantial protection, but for a limited period, over a limited area, with respect to a limited activity. However, they demand the employer be proactive about its protection and only give that protection if the employer has included in the employment contract a valid restraint of trade clause. If an employer has a restraint of trade clause in its contract and that clause is valid, it means complete protection for a defined activity, over a defined period of time in a defined area. However, no restraint of trade clause or an invalid restraint of trade clause means no protection for know-how whatsoever. There are no halfway houses in this area of practice.

It is a constant surprise that around 50 per cent of the clients I see have no restraint of trade clauses in their contracts and are left trying to prove the information can be classified as a trade secret – which is problematic. Thousands will be spent on the firm's security but nothing on protecting the business's most valuable asset. A large proportion of the other 50 per cent have restraint of trade clauses which have been incorporated from any number of unlikely sources which are clearly invalid. The employer is left completely vulnerable, losing hundreds of thousands of dollars of business unnecessarily.

Once the employer's lawyer has advised his or her client that "an employment contract without a restraint of trade clause is like a backdoor without a bolt", the question to answer is will the bolt hold, that is, is the clause valid?

Drafting a restraint of trade clause that will withstand an attack is more an art than a science. But as recent cases show, just as in art, there are important principles to follow.

DOES THE COURT DENY AN EX-EMPLOYEE WORK OPPORTUNITIES OR DOES IT RISK SUBSTANTIAL DAMAGE TO AN EMPLOYER'S LIVELIHOOD?

The canvass behind the art is understanding the clearly enunciated time-honoured policy behind restraint of trade clauses. The first step is always to think in the context of the policy. Unlike vendor-purchaser restraints, where the intention of the parties is central, employer-employee restraints in employment agreements are on their face objectionable for two reasons.

The first, lurking not far beneath the surface, was rarely mentioned but has recently received some exposure in *Artcraft Pty Ltd v Chandler*.[13] It is the unequal bargaining position of the employee applying for a job compared with the position of strength of the employer when agreeing to restraint terms. This policy translates into the court, sometimes covertly, being protective of the employee.

The second, and official policy, is that it is in the community's interest that all its citizens' skills are used to the maximum. Hence restraint of trade clauses in employment contracts are, on an in personam scale, invalid because they fetter competition between the employer and ex-employee and on a broader scale are invalid because they endanger the vibrancy of a free enterprise economy.[14] This was described in the leading case of *Nordenfelt Guns and Ammunition Co Ltd*[15] as:

"The public have an interest in any persons carrying on his trade freely; so has the individual. All restraints of trade of themselves, if there is nothing more, are contrary to public policy, and therefore void. That is the general rule. But there are exceptions . . .

"It is sufficient justification, and indeed, it is the only justification, if the restriction is reasonable – reasonable, that is, in reference to the interests of the parties concerned and reasonable in reference to the interests of the public, so framed and so guarded as to afford adequate protection to the party in whose favour it is imposed while at the same time it is in no way injurious to the public". (See also *Mason v Provident Clothing and Supply Company Limited*.[16])

Understanding the policy makes understanding the principles of drafting restraint of trade clauses easy. This policy that the restraint must be reasonable with reference to the protectable interest of the parties is at the heart of most judgments. In practice these policies mean:

- when enforcing a restraint of trade clause the employer faces a reversal of the burden of proof (both evidentiary and legal); and
- there is a central need to isolate what is the "interest" that the employer is protecting.

From this base there is a series of truisms that every lawyer needs to know when drafting a restraint of trade clause. In order of priority they are:

(a) The client will wish to have his lawyer draft a restraint that protects everything including heaven and earth for all time. The lawyer's skill is to explain to the client (preferably in writing) that less is more. Better to err on the side of less protection with certainty of validity, than risk more protection only to fail the burden of proof and see the clause struck down.

(b) The very first step in drafting a restraint of trade clause is to determine the "interest" that the client is protecting and then protect that and only that interest. If the client is a wholesaler of shoes with no retail outlets, to restrain the employee from working "in the shoe industry" is asking for trouble. This is dealt with under "Latest refinements" below.

(c) The client's interest is limited to keeping its existing clients during the vulnerable period when, say, its leading salesman first goes to work for an opponent, not binding those clients to itself forever.

As reiterated this year in *Koops Martin v Dean Reaves*,[17] the central rule for determining the period of a valid restraint clause is to understand that the time the courts will give your employer client to operate free of the ex-salesman's otherwise perfect right to compete is only so long as it will take your client to re-establish the connection between its customers and its new replacement salesman.

That is the time your client remains unfairly vulnerable. As noted in another case this year, *Kearney v Crepald & Ors*[18] (*Kearney*), the length of time is influenced by the strength of the bond between the ex-employee and the customer. For example, in the insurance industry, where the salesman-customer relationship is strong and cyclic, a restraint for 12 months against contacting clients with whom the ex-employee dealt for the past 18 months may be reasonable.[19] But where the connections are fleeting or voluminous, for example the used car industry, six months may be excessive.[20] Furthermore, as was demonstrated last year in *Harlow Property Consultants Pty Ltd v Byford*,[21] if that ex-employee could not possibly have known the protected customers the clause will be struck out.[22]

LATEST REFINEMENTS

One of the most difficult decisions facing the courts in this area has been what to do at the interlocutory stage. Does the court deny an ex-employee work opportunities or does it risk substantial damage to an employer's livelihood? The courts have found a way to be more proactive at the interlocutory stage.

In a restraint of trade case, *Kearney*,[23] McDougall J said: "Normally the court 'does not undertake a preliminary trial, and give or withhold interlocutory relief upon a forecast as to the ultimate result of the case' . . . [but], there are some kinds of cases in which for the purpose of seeing where lies the balance of convenience (or more specifically the balance of risk of doing an injustice) . . . it is desirable for the court to evaluate the strength of the plaintiff's case for final relief . . . ".[24]

So, even though the validity of the restraint is a matter of law to be determined at trial,[25] an employer's legal representatives have to be ready, at the interlocutory stage, for a battle over the strength of the clause, albeit with "a broad brush".[26] The courts may strike middle ground, enabling a defendant to keep trading while giving some respite to the plaintiff.[27]

Another area recently dealt with concerns the ex-employee poaching the previous employer's employees. Conventional thinking was that an employer had a legitimate protectable interest in maintaining a stable and trained workforce. However, it would seem that this is not sufficient ground on its own for restricting ex-employees from poaching their workmates.[28] In fact, it may now be no justification at all, unless there is some confidential information accompanying the employment of the poached employee.[29]

The thorny question of just how much preparation for their new competing venture employees can undertake before terminating their employment has received further attention. It now appears that if the employer knew or ought to have known that this was being done, but did not act, the ex-employee will escape sanction despite much preparation. It is a reaffirmation of the principle that in these cases delay is deadly.[30] But as an employee recently found, calling customers under a pretext and "inadvertently" advising them you are leaving, ends up in an injunction.[31]

After much confusion it is helpful to know that ladder clauses (or as some people call them "cascading clauses"), which can often save an otherwise invalid restraint, are permitted by the courts subject to the following principles:

- the number of combinations should be relatively few;
- there must be a genuine attempt to define the predictable interest;
- there must be realistic severance provisions.[32]

It is also important to heed the recent warning that the rule of thumb that it was best always to join the ex-employee's new employer in any court proceedings may need a rethink. It is probably no longer the norm unless there is independent evidence of its complicity.[33]

BEDSIDE MANNER

When an employer wakes up one morning and finds that his best sales manager did not leave to tend a sick mother but rather to start up an identical business across town and is courting all the employer's best clients, the initial reaction is not one of goodwill to all men and women, particularly towards the ex-sales manager. Hence, whether or not the employer had the foresight to ask his lawyers to draft a valid restraint of trade clause, I can say from much experience that the employer's understandable attitude is that this is unfair, and the law must be able to stop it and, furthermore, the ex-sales manager must have done something underhand.

Often the departing sales manager has been careful and calculating. In the absence of a valid restraint clause, the courts require concrete evidence of infidelity. In the further absence of direct evidence arising from preventative measures such as records of access to and removal of data courtesy of a previously installed security data access tracking program, the client must fall back on the rocky ground of circumstantial evidence such as "coincidental" errors in mirror lists or the speed at which customers were contacted. Obviously, it is the client's responsibility and not the lawyer's to find this evidence. Such advice has an immediately sobering effect on its misplaced enthusiasm.

As the case of *AMI Maintenance Ltd v Brunt*[34] demonstrates, it is as well always to be aware of the employee who, over time, has come to know more about his or her employer's customers, and has become closer to those customers, than the employer and to take preventative measures. ●

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1. [1986] 3 WLR 288. See, for example, *Maggbury Pty Ltd v Hafele Australia Pty Ltd & Anor* (2001) 210 CLR 181; *Mincom Limited v Oniqua Pty Ltd* (2006) QSC 155; *Southern Cross Financial v Rodrigues* [2005] NSWSC 261; *Consolidated Paper Industries Pty Ltd v Matthews* [2004] WASC 161; *IF Asia Pacific Pty Ltd v Galbally & Ors* [2003] VSC 192.
2. Robert Dean, *Employers, Ex-Employees and Trade Secrets*, LBC, 2004, 3.1.
3. [1978] 3 All ER 193, 207.
4. Kirby J in *Wright v Gasweld Pty Ltd* (1991) 22 NSWLR 317, 334; *AMI Maintenance Ltd v Brunt* [2004] WASC 49; *Returned Services League of Australia v Comprite* [2005] QSC 361; *Koops Martin v Dean Reeves* [2006] NSWSC 449.
5. Note 1 above, at [61].
6. [1965] RPC 239, 255.
7. [1967] VR 37, 40.
8. Note 1 above.
9. *Balston Ltd v Headline Filters Ltd* (1987) FSR 330; *Independent Management Resources Pty Ltd v Brown* [1987] VR 605.
10. *Artedomus (Aust) Pty Ltd v Del Casale* (2006) 68 IPR 577.
11. *AP Generations Pty Ltd v Feneley* (2001) 80 SASR 15; see also *Worsley & Co Ltd v Cooper* (1939) ALL ER 290; *Brents Brewery Co Ltd v Luke Hogan* [1945] 2 All ER 570.
12. *Fisher-Karpark Industries v Nichols* [1982] FSR 351; *International Scientific Communications Inc v Patterson* [1979] FSR 429.
13. [2003] QSC 102, [23]; see also *Liberty Finance Pty Ltd and Anor v Scott & Anor* [2005] VSC 26 at [35].
14. *Tank Lining Corp v Dunlop Industries Pty Ltd* (1982) 140 DLR (3d) 959, 662.
15. [1894] AC 535.
16. (1913) AC 724, 738.
17. Note 4 above, at [30].
18. [2006] NSWSC 23 at [48].
19. *SGP Insurance Brokers v Marisa Rockett* [2006] NSWSC 117 [23].
20. See generally *Port or Software International Pty Ltd v Bodsworth* [2005] NSWSC 631.
21. [2005] NSWSC 658 at [29].
22. *Koops Martin*, note 4 above.
23. Note 18 above, at [12].
24. See also *Monash Real Estate Pty Ltd v Ross* [2005] VSC 116, [14]ff; and *Lamberts Brothers v Kentish* [2005] SADC 99 at [34].
25. *Nuera (Aus) Pty Ltd v Bain* [2005] NSWSC 24.
26. *Queensland Cosmetic Manufacturers Pty Ltd v Greig & Ors* [2005] QSC 334 at [13].
27. Note 26 above, at [13].
28. *Aussie Homeloans v X Inc Services* [2005] NSWSC 285 at [22]-[26].
29. Note 18 above, at [58].
30. Note 18 above, at [68].
31. *APM Services Limited v Manning* [2006] FCA 256.
32. *Hydron Pty Ltd v Harous* [2005] SASC 176.
33. *Woolworth Limited v Mark Conrad & Anor* [2004] NSWSC 849 at [27].
34. Note 4 above.