Restrictive Covenants

Marcus Dowling

09 May 2018

1. In this paper I will discuss briefly some issues that arise in relation to the enforcement – or otherwise – of restrictive covenants in employment contracts. The basic position is as follows:

    a. Contracts in restraint of trade are *prima facie* unenforceable.

    b. A Court will only enforce such contracts if they are reasonable with reference to the interests of the parties concerned and the public at large.

2. When asked to advise whether or not a particular restraint is likely to be enforceable, the start point is usually a simple and practical analysis based upon the nature of the restraint, the length of the restriction and the seniority of the employee. Where the restraint is short and limited in scope then it may be possible to say with some degree of confidence that it will enforced. However, such restraints rarely give rise to litigation. Where a dispute warrants the involvement of lawyers, it is often impossible to give any definitive view as to the prospects of obtaining or defending an application for an interlocutory injunction. This lack of certainty can be a source of frustration and stress for clients. However, it is hardly surprising when one considers the bewildering array of issues that can arise in such cases. Some of those issues – in respect of which there have been recent developments – are discussed below.

Illegality

3. The *"somewhat anomalous doctrine of restraint of trade"*[1] is an example of the doctrine of illegality, an area of the law described by the authors of a recent edition of Chitty in the following terms:

[1] Esso Petroleum Co. Ltd v Harper's Garage (Stourport) Ltd [1967] UKHL J0223-1 at page 4

"…the courts have conceded that "[I]llegality and the law of contract is notoriously knotty territory" and that it is "one of the least satisfactory parts of the law of contract." Speaking extra judicially, Lord Sumption stated that "law of illegality is an area in which there are few propositions, however contradictory or counter-intuitive, that cannot be supported by respectable authorities of the highest levels". In a similar vein Lord Mance has characterised the law on illegality as "an unhappy mix of rigid rules and value judgments, and its application has unpredictable and haphazard consequences". He considered that "by the end of the twentieth century it had become encrusted with an incoherent mass of inconsistent authority."[2]

4. The reason for the chaos described above is (or was) the reluctance of the Courts to enforce the illegality doctrine strictly. The absolutist position – if a contract is tainted by illegality it will not be enforced – has the obvious potential for giving rise to injustice. As explained by Clarke J in *Quinn v IBRC [2015] IESC 29*:

"The principal judgment was given by Lord Sumption. Having traced the doctrine to Holman v. Johnson (1775) 1 Cowp. 341 , Lord Sumption noted, at para. 14, p. 440, that this area has given rise to "a large body of inconsistent authority which rarely rises to the level of general principle". He also noted that the main reason for the disordered state of the case law is the distaste of the courts for the consequences of applying their own rules, consequences which he noted Lord Mansfield had pointed out two centuries ago. That is, indeed, the fundamental problem already identified in this judgment. A strict application of a rule of unenforceability in relation to all contracts tainted by illegality can have consequences which may appear very unjust on the facts of an individual case. That leads to attempts to find, normally by way of exception, a basis for avoiding the full rigours of the rule in cases where the consequence may appear to be particularly unjust."

[2] Chitty, 32nd Edition at paragraph 16-002 – substantially revised as a consequence of the decision in Patel v Mirza referred to below

5. In the UK the law on illegality has been turned on its head by the decision of the Supreme Court In *Patel v Mirza [2017] AC 467.* Mr. Patel leant Mr. Mirza money to speculate on the price of RBS shares using insider information. In the event, no speculation took place but when Mr. Patel sought the return of his money, Mr. Mirza refused to repay him. Confusingly the case was decided on a relatively simple basis, i.e. that Mr. Patel was entitled to repayment of the money on the basis that his claim for unjust enrichment did not depend upon the illegal act. In a wide ranging and detailed analysis – which in light of the narrow basis upon which the case was decided was arguably *obiter* - Lord Toulson (with which four other members of the court agreed) said that it is no longer appropriate to consider whether a contract is *"tainted by illegality "*. Instead, the court must:

   "have regard to the policy factors involved and to the nature and circumstances of the illegal conduct in determining whether the public interest in preserving the integrity of the justice system should result in denial of the relief claimed. I put it in that way rather than whether the contract should be regarded as tainted by illegality, because the question is whether the relief claimed should be granted "

6. Lord Toulson said that relevant factors when looking at the question of whether to refuse relief to a claimant who would otherwise be entitled to it include

   "the seriousness of the conduct, its centrality to the contract, whether it was intentional and whether there was marked disparity in the parties' respective culpability "

7. He summarised the position as follows:

   "The essential rationale of the illegality doctrine is that it would be contrary to the public interest to enforce a claim if to do so would be harmful to the integrity of the legal system (or, possibly, certain aspects of public morality…). In assessing whether the public interest would be harmed in that way it is necessary (a) to consider the underlying purpose of the prohibition which has been transgressed and whether that

purpose will be enhanced by denial of the claim, (b) to consider any other relevant public policy on which the denial of the claim may have an impact and (c) to consider whether denial of the claim would be a proportionate response to the illegality, bearing in mind that punishment is a matter for the criminal courts. Within that framework, various factors may be relevant, but it would be a mistake to suggest that the court is free to decide a case in an undisciplined way. The public interest is best served by a principled and transparent assessment of the considerations identified, rather than by the application of a formal approach capable of producing results which may appear arbitrary, unjust or disproportionate".

8. Lord Toulson's conclusion was based upon preferring the *"range of factors"* approach to the issue rather than a *"rule based"* approach. Lord Toulson made several references to passages from an academic text, *Restatement of the English Law of Contract, Professor Andrew Burrows* and it should be noted that the passages in that text to which his conclusions refer specifically reference contracts in restraint of trade.

9. The issue considered by the Irish Supreme Court in *Quinn v IBRC* was narrower in scope and the detailed analysis in Clarke J's judgment focuses on the consequences of statutory illegality. There is reference to the judicial controversy that preceded the decision of the UK Supreme Court in *Patel v Mizra*, which is to the effect that a narrower rule based approach is to be preferred to *"range of factors"* approach advocated by Lord Toulson:

"[141] A starting point has to be to note that the question which was, at least for the time being, resolved in the United Kingdom in Tinsley v. Milligan [1994] 1 A.C. 340 has not been expressly considered in any detail in this jurisdiction in recent times. In my view, this court is, therefore, free to consider the proper approach to adopt in the light of principle and precedent. I am also persuaded that there is much to be said for the criticism identified by Lord Sumption in Les Laboratoires Servier v. Apotex Inc [2014] UKSC 55 , [2015] A.C. 430 of the approach which sought to turn the principle of illegality from a rule of law into a power which could be exercised by the court on a

discretionary basis depending on the merits of the case. Whatever may be the disadvantages of the rule of law approach, the uncertainty which would be created by leaving the question of enforceability up to a very broad consideration by a trial judge on the facts of any individual case would arguably be worse.

[142] However, the approach adopted in cases such as Euro-Diam Ltd. v. Bathurst [1990] 1 Q.B. 1 sought to solve the problem of attempting to balance, on the one hand, the public policy requirement that courts not act in aid of illegal activity with, on the other, the injustice to which a "lie where it falls" approach can give rise by inviting the court to decide each case on its own merits. An alternative approach, which seems to me to give rise to a much greater degree of certainty, seeks to reconcile the competing principles by having regard to what may be seen to be the policy requirements of the relevant statute which creates the illegality in the first place. On that basis, a court is required to assess whether the requirements of public policy, in respect of a particular statutory provision rendering, as a matter of the public law of the State, a particular type of activity illegal, require that contracts sufficiently connected with that particular type of illegality are to be regarded as unenforceable. Such an approach requires each statutory regime (or part of a statutory regime) to be independently assessed to determine whether policy requires particular types of contracts to be treated as unenforceable. However, such an approach does not mandate the court to take a different view as to whether one particular contract or another may be regarded as unenforceable by virtue of being in breach of the same statutory provision by reference to, for example, the severity of the breach concerned or the adverse consequences for the parties. The proper approach, in my judgement, is statute specific but is not case specific."

10. However, in discussing the type of factors that the Court may take into account in making a determination on a *"statute specific"* basis, Clarke J does make some comments that are in keeping with the approach advocated in *Patel v Mirza*:

"[159] In a highly regulated age, it seems to me that there may be an argument to the effect that a more nuanced approach is to be preferred. To treat every contract

which might be said to be tainted by illegality as unenforceable, with all the potential for injustice to individual parties which such an approach would carry, may well not be consistent with modern policy requirements. As noted earlier, it is important to emphasise that it is open to the Oireachtas to determine whether particular categories of contract are to be regarded as unenforceable by reference to any aspects of a regulatory regime which the Oireachtas determines warrant such an approach. But where the Oireachtas has chosen not to expressly require that such contracts not be enforced, does it necessarily follow that policy always requires that the courts necessarily treat such contracts as unenforceable? There is, of course, nonetheless, the important policy requirement, which stretches back to Holman v. Johnson (1775) 1 Cowp. 341 , and which is to the effect that the courts should not lightly be seen to be giving effect to contracts which are tainted by illegality. But modern experience demonstrates that there are other important policy considerations involved as well. Neither should the courts be readily seen to refuse to enforce otherwise binding commitments (where not expressly provided by statute) which can lead to injustice and consequences which are significantly disproportionate to the illegality concerned. Treating contracts as unenforceable in all circumstances can be as likely to lead to a breach of legitimate public policy requirements as to acting in their aid.

[160] It seems to me to follow that, at least at the level of general principle, there is a case for a more nuanced approach, which seeks to identify the criteria by reference to which contracts tainted by illegality are to be regarded as unenforceable. Such an approach might be said to be mandated by the modern requirements of policy in a highly regulated age."

11. An often overlooked element in an analysis of restrictive covenants are the authorities dealing with the underlying public policy justification for the rule. It is – rightly – assumed that virtually every provision will operate as a restraint of trade. In fact, concluding that a restrictive covenant does operate as a restraint of trade is often easiest part of the analysis that a lawyer is asked to undertake. The activities

that the restrictive covenant enjoins will inevitably be things that the person would otherwise do in:

"the free exercise of his trade or business, by restricting him in the work he may do for others, or the arrangements which he make with others…"[3]

12. However, while the effect of the rule may be clear, the reasons for the underlying prohibition are not. In *Esso Petroleum Co Ltd v Harper's Garage (Stourland) Ltd. [1968] AC 269*, the members of the House of Lords struggled with the scope and underlying rationale for the doctrine. Lord Wilberforce said:

"The doctrine of restraint of trade (a convenient, if imprecise, expression which I continue to use) is one which has throughout the history of its subject-matter been expressed with considerable generality, if not ambiguity. The best known general formulations, those of Lord Macnaghten in Nordenfelt [1894] A.C. page 565 and of Lord Parker of Waddington in Adelaide [1913] A.C. 793-7 , adapted and used by Diplock L.J. in the Court of Appeal in the Petrofina case [1966] Ch. 146, 180 , speak generally of all restraints of trade without any attempt at a definition. Often we find the words "restraint of trade" in a single passage used indifferently to denote, on the one hand, in a broad popular sense, any contract which limits the free exercise of trade or business, and, on the other hand, as a term of art covering those contracts which are to be regarded as offending a rule of public policy. Often, in reported cases, we find that instead of segregating two questions (i) whether the contract is in restraint of trade, (ii) whether, if so, it is "reasonable", the courts have fused the two by asking whether the contract is in "undue restraint of trade" or by a compound finding that it is not satisfied that this contract is really in restraint of trade at all but, if it is, it is reasonable. A well-known text book describes contracts in restraint of trade as those which "unreasonably restrict" the rights of a person to carry on his trade or profession. There is no need to regret these tendencies: indeed, to do so, when consideration of this subject has passed through such notable minds from Lord

[3] Per Denning MR in Petrofina (Great Britain) Limited v Martin [1966] Ch 146

Macclesfield onwards, would indicate a failure to understand its nature. The common law has often (if sometimes unconsciously) thrived on ambiguity and it would be mistaken, even if it were possible, to try to crystallise the rules of this, or any, aspect of public policy into neat propositions. The doctrine of restraint of trade is one to be applied to factual situations with a broad and flexible rule of reason."

13. The *"general formulation"* in the *Nordenfelt v. Maxim Nordenfelt Guns and Ammunition Co. [1894] A.C. 535* was as follows:

"All interference with the individual liberty of action in trading, and 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: restraints of trade and interference with individual liberty of action may be justified by the special circumstances of a particular case. It is a 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."

14. The considerations with which practitioners are very familiar – whether the employer has demonstrated that he has legitimate business interests which merit protection and whether the covenant is no wider than reasonably necessary to protect those interests – are drawn from this general formulation.

15. Does any of the foregoing have any practical implications? Possibly not. However, I would suggest that the decisions of the Supreme Court and the UK Supreme Court do have potential relevance to practitioners in the employment area:

    a. If Patel v Mirza was regarded as persuasive authority, it could provide a basis for defeating an illegality defence even if a restrictive covenant was otherwise unenforceable on a normal analysis; and

b. Such an argument would undoubtedly be met with the counter that Clarke J ruled out the *"range of factors"* approach by his comments in Quinn v IBRC. However, in light of the somewhat peripheral nature of those comments to Clarke J's overall analysis, the position is not completely clear cut.

16. Obviously any such arguments would be – to put it mildly – a long shot. However, there are situations in practice where one encounters situations where an employee or partner or former business owner has obtained enormous - by any measure - benefits and is at the same time arguing that the restrictions that he or she agreed to in connection with those benefits should not be enforced.

Negative Declarations

17. An incidental issue that arose in the *Quinn v IBRC* proceedings was the form of action taken by the Quinns and whether or not it amounted to a *"cause of action"* for the purpose of certain statutory provisions. Clarke J said:

" … it is well settled in this jurisdiction that, at least in certain cases, a party can seek a so-called "negative declaration". While the precise parameters of the circumstances in which such declarations can be obtained have not yet been fully established, the underlying rationale is clear.

… in the absence of an ability to apply for a negative declaration, the relevant party would be left with the claim hanging over them until such time as either the claimant sues (in which case the matter will be resolved by the court) or withdraws its claim or, indeed, allows the period provided in any relevant statute of limitations to expire. It is clear that such a situation could create a significant injustice for the party against whom the claim is made who may be left with the claim hanging over them for some considerable period of time. It is in that context that the courts have been prepared to allow that party to itself commence proceedings designed to bring clarity to the question of the liability which that party denies.

While, however, in such circumstances, the party against whom the claim is asserted will be the plaintiff and the claimant will be the defendant, it seems to me that that procedural position does not alter the substance of the issue, which is that it is the claimant who asserts a liability and the plaintiff who denies it. In a case where, whether for reasons of illegality or otherwise, the contract on which the claim was asserted is unenforceable, it does not seem to me that the result of the case could conceivably depend on whether the claimant brings proceedings as plaintiff or the person claimed against brings proceedings seeking a negative declaration. Either the claim is enforceable or it is not. If the person claimed against could resist a claim on the grounds of unenforceability, I can see no reason why that same party cannot, as plaintiff, successfully obtain a negative declaration to the effect that the claim is unenforceable."

18. In *Hernandez v Vodafone Ireland Limited [2013] IEHC 70*, the plaintiff sought an interlocutory injunction restraining the defendant from interfering with his contract with his new employer on the basis of a non-compete clause. Significantly, on the facts of that case there had been direct correspondence between the defendant and the plaintiff's new employer. Laffoy J granted an interlocutory injunction restraining the defendant from further interference with the contract between the plaintiff and the new employer. Clarke J's comments in *Quinn v IBRC* show that the approach adopted in Hernandez is not as radical as it is sometimes characterised.

Special rules for the enforcement of negative covenants

19. One of the most difficult issues for a plaintiff seeking to enforce a restrictive covenant is obtaining an interlocutory injunction where the effect of the order may be to prevent a former employee from working. It should be said that this is an issue that arises less frequently than it once did; employers rarely seek to enforce restrictions against competition per se and if an employee cannot work without breaching non-solicit or non-deal restrictions that will often mean that they are in a vulnerable position in any event.

20. In *Metro International SA v. Independent News and Media plc [2006] 1 ILRM. 414* , Clarke J. quoted with approval the summary of McCracken J. from *B. & S. Limited v. Irish Auto Trader Limited[1995] 2 IR 142*:

"1. An interlocutory injunction should be refused if damages would adequately compensate the plaintiff for any loss suffered between the hearing of the interlocutory injunction and the trial of the action provided the defendant would be in a position to pay such damages.

2. Should this test be answered in the negative an interlocutory injunction should be granted if the plaintiff's undertaking as to damages would adequately compensate the defendant, should he be successful at the trial, in respect of any loss by him due to the injunction being in force between the date of the application for the interlocutory injunction and the trial, again assuming that the plaintiff would be in a position to pay such damages.

3. If damages would not fully compensate either party, then the court may consider all relevant matters in determining where the balance of convenience lies, but these will vary depending on the facts of each case.

4. It is normally a council of prudence, although not a fixed rule, that if all other matters are equally balanced, the court should preserve the status quo.

5. Again, where the arguments are finally balanced, the court may consider the relative strength of each party's case as revealed by the affidavit evidence adduced at the interlocutory stage where the strength of one parties case is disproportionate to that of the other."

21. Clarke J. analysed the issue of loss in the following terms:

"4.4 It is also, perhaps, important to note the nature of the type of loss which must be assessed as to whether it might be compensatable in damages. As is pointed out by McCracken J. at item 1 of the test set out above it is the loss which would flow between an injunction being granted at the interlocutory stage on the basis of the plaintiff having established a fair issue to be tried up to the time of trial where that issue was ultimately found against the plaintiff. There are, of course, cases where even at trial damages would be an adequate remedy and where, in accordance with the established jurisprudence of the courts, an injunction will not normally be granted even though the plaintiff succeeds in establishing wrongdoing. There are, however, on the other hand, cases where the courts have traditionally not been prepared to award damages even though there is a sense in which any relevant loss could be calculated in monetary terms. Thus in many cases where a plaintiff alleges an infringement of his property rights the court will intervene by injunction where those property rights have been established rather than compensate the plaintiff for the loss of those property rights… Thus the mere fact that a property right (or indeed a diminution in such a right) can be valued in monetary terms does not of itself mean that damages for an infringement of that property right can necessarily be said to be an adequate remedy.

4.5 While it may well be that a temporary short term interference with a disputed property right (resulting from a failure to grant an interlocutory junction) may not give rise to quite such a clear-cut situation, it is nonetheless, in my view important for the court to take into account in addressing the question of whether damages may be an adequate remedy (for the period identified by McCracken J. in Irish Autotrader) whether the nature of the matter which is alleged to be interfered with is the kind of matter which the courts have traditionally held should be protected by injunction rather than simply compensated for in damages. Clearly property rights are one such category…

4.6 Similarly in Dublin Port and Docks Board v. Britannia Dredging Co. Limited [1968] I.R. 136 the Supreme Court, following Doherty v. Allman (1878)3 App. Cas. 709 accepted that where it is established that a party has agreed to a negative covenant

a court, at least at the trial of an action, will prima facie enforce the covenant even though it may be possible to measure the loss that would be attributable to its non performance in monetary terms. Thus enforcement of a negative covenant may be another type of case where the courts lean in favour of enforcement by injunction rather than compensation.

4.7 In Irish Shell Limited v. J.H. McLoughlin (Balbriggan) Limited (Unreported, High Court, Clarke J. 4th August, 2005) I had regard to the latter above principle in respect of a negative covenant as a factor to be taken into account in the grant of an interlocutory injunction when taken in conjunction with the fact that, in that case, a permanent injunction might well have been of little benefit if obtained at trial having regard to the purpose for which the covenant concerned had allegedly being entered into.

4.8 While fully accepting, therefore, that the primary consideration of the court in assessing the adequacy or otherwise of damages at the interlocutory stage is the loss that might be sustained in the period between the refusal of an interlocutory injunction (or indeed its grant and the reliance by a defendant upon the undertaking as to damages given to secure it) and the trial I am nonetheless of the view that in assessing the adequacy or otherwise of such damages as a remedy the court can and should have regard to the question of whether the right sought to be enforced or protected by interlocutory injunction is one which is of a type which the court will normally protect by injunction even though it might, in one sense, be possible to value the extinguishment or diminution of that right in monetary terms."

22. In *Sports Direct Plc v Minor and others [2014] IEHC 546* Costello J referred to the fact that the plaintiff was seeking an interlocutory injunction to enforce a negative covenant in relation to both the balance of convenience and the issue as to whether or not the plaintiff could be adequately compensated by damages:

"Secondly, it is a right in the nature of a negative covenant. This is particularly significant in the light of the decision of the Supreme Court in Dublin Port and Docks

Board v. Britannia Dredging Co. Ltd.[1968] I.R. 136 and the decision of Clark J. in Shell Limited v. J.H. McLoughlin (Balbriggan) Limited (Unreported, High Court, Clarke J. 4th August, 2005) quoted above in para. 31. The enforcement of a negative covenant is one where the courts lean in favour of enforcement by injunction. This applies whether the court forms the view that the case is so strong that the court does not have to assess the question of either the adequacy of damages or the balance of convenience or where the court determines damages would not be an adequate remedy. It is clearly also relevant to the question of where the lesser risk of injustice lies. Further, the enforcement of the rights of a shareholder pursuant to a shareholders agreement is an interest concerning the entitlement to exercise the rights and privileges attaching to the shares as was the case in Ancorde Limited."

23. Barrett J subsequently applied the same principles albeit in Camiveo Ltd v Dunnes Stores [2017] IEHC 147. Accordingly, if acting for a plaintiff in an application to enforce a restrictive covenant it is important to reference the *Brittania Dredging* authorities.

End