Restraint of Trade in Contracts of Employment

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An agreement by which someone is restricted in his freedom to carry on his trade, profession; business, employment or other economic activity is generally called an agreement in restraint of trade. Such a restraint is usually intended to protect the economic interest of the party in whose favour it is imposed.

Clauses pertaining to restraint of trade are often found in commercial contracts as well as in contracts of employment. The enforceability of such clauses had been always subject to heavy contest and the courts appear to have considered the issue as a question of fact with regard to the extent of restraint. Contracts of employment may contain two types of clauses. The employer may prohibit an employee from carrying on any business or having an interest in any business in general or a business which is in conflict with the employers business whilst in employment. Such clauses may prohibit an employee from engaging in any other financially gainful employment. Such clauses often require the employee to devote his whole time and to the discharge of the employer's duties. Some clauses may have a blanket restriction that an employee is prohibited from engaging in any activity financially gainful even outside his duty hours.

Contracts of employment may also contain clauses restricting the employee accepting another employment of the same nature using the same skills after the determination of the contract of employment. Some of these clauses may specifically restrict any employee engaging in businesses that may compete with the business of the former employer. This kind of clauses would apply after the termination of employment with the former employer.

The clauses in restraint of trade, though prima facie reflect the free will of the parties, the question would arises as to whether such clauses could be enforced in law. In a contract of employment, a covenant in restraint of trade is invalid unless three conditions are fulfilled: there must be an interest meriting protection; the restraint must be reasonable; and it must not be contrary to public policy[1]. The interest must necessarily arise from the relationship of the parties; employer and employee.

There appears to be a distinction between English law and Roman Dutch Law to the approach of considering whether the said clauses are enforceable in law. The

[1] Treitel, G. H; Law of Contract, 10th Edition, p 416, Sweet and Maxwell (International Student Edition) 1999.

rule in English Law is that restraint of trade is *prima facie* illegal and void.[2] If however in the circumstances the restraint is reasonable between the parties (inter parte) and not against the public interest, it is valid and enforceable .According to the English Law the party who wishes to enforce a restraint of trade has the burden of proof to establish that the clause is legal and reasonable. Chitty[3] states that all contracts of restraint of trade are *prima facia* unenforceable at common law. Chitty here refers to English common law.

On the other hand, in Roman Dutch Law, restraint on trade may be enforceable in principle as any other term of contract, subject however to the objection by the party against whom it is enforceable that the clause was unreasonable and against public policy and therefore illegal.[4] Thus the burden of proof will be in the party against whom the clause is operative.

Both the above legal systems finally may adopt the same criteria; the reasonableness and public policy considerations in determining whether a clause pertaining to restraint of trade is permitted to be enforced subject however to the requirement of sufficient interest. Therefore the difference under Roman Dutch Law and English Law appears to be on whom the burden of proof lays.

It is thus important to consider the distinction between the requirements under two legal systems as the law governing contract of employment in Sri Lanka is Roman Dutch Law. Although there are several statutory interventions, interfering with the freedom of contract between the employer and employee on the basis that the parties are not of equal bargaining power, many aspects of contract of employment is still governed by the principles of Roman Dutch Law. The common law of Sri Lanka, the Roman Dutch Law, governs the question whether a relationship of employer and employee exists between two persons and whether there is a valid contract of employment.[5] The law relating to the vacation of post is also governed by the common law of Sri Lanka. In *Wijenayeke v. Air Lanka*[6], the Supreme Court held that the duty of the employer to grant a hearing in a case of vacation of post was governed by Roman Dutch Law. Despite several statutory interventions to the contract of employment, Roman Dutch Law still remains the foundation of the contract of employment.

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[2] Van der Merve, Van Huyssteen and Reincke;Contract - General Principles 3rd Edition Pg 214, Juta & Co. Ltd 2007.

[3] Chitty on Contracts (27th Edition) para 16-066 .

[4] Carts v Etthimiou 1948(4)SA 603(O) 613

[5] S.R. De Silva, The Contract of Employment, page 23, No. 4 – (Revised Edition); Employers' Federation of Ceylon. 1998.

[6] [1990] 1 Sri Lanka Law Reports, 293.

Further, the Introduction of Laws of England (Civil Law Ordinance) No: 5 of 1852 was to cater to the above need which introduced into Ceylon the Laws of England in certain cases, e.g. Maritime matters, commercial matters etc.

The application of English law was limited to the areas set out in section 2 and 3 of the Civil Law Ordinance where there is no reference to labour law or like area. Therefore it is beyond doubt that the law applicable to contracts of employment is Roman Dutch Law, subject however to the statutory interventions.

Weeramantry J. in *De Costa Vs. Bank of Ceylon* stated;

> *for all these reasons, I conclude that in terms of the proclamation of 23rd September, 1799 the Common Law of Ceylon was the Roman Dutch law, subject to such deviation and alteration and the specified authorities might determine but that the authorities thus expressly empowered to make deviations did not include the Courts……*
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> *The Roman Dutch Law was thus firmly enthroned as the Common Law of this Country subject to such deviation as might be legislatively ordained*

The Interest

The interest must arise from the relationship of the parties. Employer and employee relationship is considered to be sufficient to enforce a covenant in restraint of trade subject to the reasonableness and public interest considerations.

Reasonableness and Public Policy/ Interest considerations

The other two considerations for the enforcement of restraint of trade as stated above *are inter parte* reasonableness of the restraint and the public policy considerations. Reasonableness is primarily determined by looking at the relationship employer and employee. It has often been held that reasonableness is a question of fact which may also depend on the geographical area of restraint, duration of restraint and the scope of restraint. However, even if the clause appears to be reasonable *inter parte* but affects the public interest, such clauses may not be enforceable, though examples of such cases are rare. Therefore it is important to consider the public policy considerations affecting agreements of restraint of trades.

Determining the public interest in this context is not an easy task. The value of freedom of trade or contract comes into context when legality of restraint of trade is in issue. On one hand the freedom of contract is the very basis of a valid contract and on the other the freedom of trade is declared a fundamental right in Sri Lanka.

The important factors to be considered when the public interest is determined are similar to the considerations for reasonableness that include the nature of the restricted activities, the geographical area in which the restriction is intended to operate, the period of restriction and the particular interest which stands to be protected by the restriction. The interest that may be legally protected will be the patrimonial interest[7]

The law of contract on restraint of trade has been simplified by the full bench decisions that was examined and approved in *Magna Alloys and Research (SA) PTY Ltd. V Ellis (1984) 4 SA 874(A).* The said judgement was quoted with approval by Didcott J in *J Louw & Co.(PTY) Ltd v Richter (1987) 2SA 237* in the following passage;

> *"from the judgements that were delivered, one learns the following, all of which is now clear. Covenants in restraint of trade are valid, like all other contractual stipulations, however they are unenforceable when, and to the extent that, there enforcement would be contrary to public policy. It is against public policy to enforce a covenant which is enforceable, one which unreasonably restricts the covenanters' freedom to trade or to work. In so far as it has that effect, the covenant will not therefore be enforced. Whether it is indeed unreasonable must be determined with reference to the circumstances of the case. Such circumstances are not limited to those that existed when the parties entered into the covenant. Account must also be taken of what has happened since then and, in particular, of the situation prevailing at the time enforcement in force"*

The above judgement which is considered as a land mark case in South Africa clears any doubt as to the enforceability of a covenant in restraint of trade, subject to the principles laid down in the said judgement.

The law relating to restraints imposed by employers on employees must be examined more closely for the reason that the parties, in a contract of employment are not considered to be of equal footing or with equal bargaining power. There are long lines of authorities abroad that the said proposition of law is outmoded[8] particularly due to state interventions by labour legislation where employers often complain that the employees are of a superior bargaining position. Therefore it is important to examine these clauses having regard to the established principles.

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[7]Supra, Contract - General Principles Juta pg 215

[8] Van der Merve, Van Huyssteen and Reincke;Contract - General Principles 3rd Edition Pg 216, Juta & Co. Ltd 2007.

Restraint whilst in employment

Lord Macnaghtan in the English case of *Nordenfelt v Maxim Nordenfelt &Co*.[9] held :

> *" it is sufficient justification, and indeed it is the only justification if the restriction is reasonable-reasonable, that is in reference to the interest of the parties concerned and reasonable in reference to the interest 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"*[10]

It has often been held that the reasonableness is a question of fact. The court should consider by enforcement of a restraint of trade whether such enforcement would deprive the livelihood of a person. In the *Ceylon Bank Employers Union v The Bank of Ceylon,* [11] the contract of employment contained the following clause;

> *"I will give my whole time and attention to the discharge of my duties and will observe the rules and regulations from time to time made by the bank for the guidance of its employees"*

The President of the Labour Tribunal took the view that, on the evidence before him, the workman had actively participated in a business called "Om Parsakthi Exchange". Further the tribunal was of the view that the employee was not only abused his position by using confidential information before the cashing of cheques but had also employed himself in some other occupation while in the employment of the respondent bank, which had also resulted in violating his secrecy containing customer accounts. Sirimanne J held;

> "*it is an implicit condition of any ordinary contract of service that workman must devote the whole time of his normal office hours to his work. But that the clause from the service agreement referred to above went far beyond such a condition and laid down that the workman could not engage himself in any other gainful employment. Therefore could not engage himself in some parallel business, profession or other employment as had happened in this case. Further in the present case the respondent bank had made the condition of this clause quite clear when in a circular sent out to all its employees it prohibited any gainful employment except with the sanction of the board of Directors.*

[9] (1894)AC 535
[10] Supra, Chitty in Contracts, General Principles Para 16-074
[11] 79 NLR 133

While upholding the validity of the above clause the court also observed that this does not mean that the workman, for instance, cannot have a poultry run at his home and sell some eggs or grows flowers for sale as a hobby during his spare time, but it certainly prevents him from engaging himself in some parallel business, profession or other employment. The question whether any such engagement falls to the former or latter category is one of fact and must depend on the circumstances of each particular case.[12]

In *Coats Thread Lanka (Pvt) Ltd v Samarasundara*[13], the respondent was employed by the appellant company as a work study assistant at the time of the alleged termination. The respondent also had been elected to the post of treasurer of the staff Welfare Association of the appellant company. Due to discrepancies in the accounts of the Welfare Association and allegations of corruption levelled against the respondent, the appellant company conducted an investigation into the said allegations. Thereafter the respondent's services were suspended without pay in order to conduct a full inquiry into the allegations.

During the course of the inquiry the respondent intimated his difficulty in attending the said inquiry on Saturdays as he had obtained employment elsewhere. Upon this revelation the appellant company considered the respondent as having repudiated his contract of employment on his own accord and volition. Subsequent to the said decision the appellant also informed the respondent by subsequent letter that his services had been terminated, in any event, in the light of the findings of the inquiry. Clause 16(c) of the contract of employment read as follows;

> "You will not be able to enter into any activities similar to that for which you are employed by this company or <u>obtain employment elsewhere while in service with us</u>.(emphasis added)

It was argued that the said breach was one that would be termed as a fundamental breach resulting in the repudiation of the contract by the employee. The respondent strenuously argued that the said clause was in restraint of trade and therefore illegal and void. J.A.N De Silva C.J referring to the *Nordenfelt* case and to the *Ceylon Bank Union Employees* case held;

> *" a person is entitled to seek employment with multiple employers so as to maximize his monthly income. When such employment impacts adversely on the quality of his work, appropriate action may be taken at that stage. Therefore I am of the view that such concerns of the employer cannot restrict a person's reasonable right to such employment at multiple establishments."*

[12] Ibid at 137
[13] [2011] BLR Vol- XVII page 37

J.A.N. de silva CJ distinguished the facts of *Ceylon bank Employees Union* Case with the present case where the respondent was not holding a responsible position and his second employment was not in conflict with the interest of the appellant company. The Supreme Court stressed the fact that a ground for dismissal of such an employee would be only in an instance where such employment has an adverse effect in the employers business and thus held that the Claus 16(c) was unreasonable and void.

Restraint of trade after termination

Certain clauses in a contract of employment may impose on an employee conditions preventing the employee engaging in a competing business or accepting employment in competitive business upon the determination of the contract of employment. Such restriction may or may not have a limitation on time. Certain contracts restrain or prohibit an employee to be employed in a competitive business within a particular geographical area. Such clauses are generally considered unreasonable unless there is some exceptional propriety interest owned by the employer that requires protection[14]. Such an interest could be only the master's trade secrets and his business connections with regards to trade as such. The employer must prove that the employee has substantial knowledge of some secret process or mode of manufacture. In *Home country's Dairy's Limited v Skilton*[15], the defendant employee, a milkman, entered into a contract whereby he agreed that for a period of one year from the termination that he would not serve or sell "milk or diary produce" to any customer of his ex-employer. It was argued that the restraint relating to the diary produce resulted in the contract being too wide as it would preclude the employee from working for a grocery shop selling, butter and cheese. The court of appeal reversing the trial judge's findings rejected this interpretation as being commercially unreasonable. The court held that from obvious intention of the parties it was clear that the restraint was intended to restrict the employee's activities only when engaged in the same type of business as of the employers. On this interpretation the clause was held valid as being reasonable to protect the customer connections of the employer.

Therefore it is seen that an employer can by covenant lawfully prohibit an employee from accepting after termination of his employment a position of which he would be likely to utilize information as to secret process or other trade secrets which have been acquired in the course of his employment.[16] However it should be noted that if the restraint is for an unreasonably long period such clauses will be held void.

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[14] Herbert Morris Ltd v Saxelby (1916) (1) AC 688

[15] (1970) 1 WLR 526

[16] Supra; Chitty on Contracts para 16-086

Public interest

Once an argument is before court, it is open to the scrutiny of the court in all its surrounding circumstances as a question of law and a determination of the issue whether the covenant should be enforced requires as a matter of public policy, that a balance should be struck between freedom of trade and freedom of contract [17]

The public interest could be taken to mean "the public welfare" or "general utility to the public" a meaning which though compelling the court to secure a difficult balance between this objective of public benefit and the other one of fairness to the individual trader. In *Texaco Ltd v Mulberry Filling Station Ltd* [18], the court held;

> "*as to the interest in the public, the expression was part of the doctrine of restraint of trade which is based on and directed to securing the liberty of the subject and not the utmost economic advantage . .....; That further, the question whether the restrain on liberty was in any particular case unreasonable had to be decided by the court in the light of the present day organization of industry and society and that on that basis the tie in the present case had imposed no unreasonable restraint on Mulberry's liberty to trade.*

In employment contracts public policy considerations may be rare and may only be limited to situations when a clause pertaining to restraint of trade may establish a monopoly to the former employer to the detriment of the public interest or where such a covenant would restrict the employees of securing adequate income out of employment.

In *Kores Manufacturing Co. Ltd v Kolok Manufacture Ltd*[19] when two companies, manufacturers of similar product, agreed that neither would employ any servant who have been employed by the other during the last five years. The defendant broke their promise and in the resulting action the argument and the decision were solely based on the criteria whether the agreement was unreasonable inters parte. The court of appeal held it to be unreasonable in that respect since it imposed upon the party a restraint grossly in excess of what was adequate to prevent a misuse of their trade secrets and confidential information. But Lord Reid and Lord Hudson have since observed that it would have been more correct to have stigmatised the agreement as contrary to public interest.[20]

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[17] Supra; Chitty on Contracts para 16-077
[18] (1972) 1 WLR 814
[19] (1959) Ch 108, (1958) 2 All ER 65
[20] Cheshire, Fifoot & Furmston's Law of Contract; p 532, 15th Edition, Oxford University Press, 2006.

The House of Lords also observed that the agreement was clearly designed to prevent employees from moving from one firm to the other in search of higher wages. The House of Lords further observed that it was against the interest of the state that a man should be allowed to contract out.

The doctrine of restraint of trade has always been applied to covenants contained in contracts of employment which limit the freedom of the employee to work after the termination of employment. Such covenants are guarded by the courts much more jealously than the other of the traditional categories of covenants to which the doctrine applies. The courts, however, clearly accepts the enforceability of such covenants provided they satisfy the test of reasonableness and more recent authorities indicate that they will not adopt extravagant interpretations to render them void.[21]

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[21] Home Countries Dairies Ltd v Skilton (1970) 1WLR 526