Non-competes and other restraints:

is it time for reform of Australian law?

Joellen Riley Munton*

Abstract

The Hon Dr Andrew Leigh MP, Assistant Minister for Competition, Charities and Treasury in the Albanese government, is convinced that the law governing the enforcement of post-employment restrictive covenants is suppressing competition and innovation in the Australian economy.[1] He is driving a review of the law, and if Australia follows developments in the United States, we are likely to see reforms in the near future.[2] This 'explainer' outlines the problem, as it is perceived in the government's Competition Review Issues Paper, and indicates potential law reforms. The author has expressed strong views of her own on the issue, in earlier academic papers, and in a submission to the review.[3] This short article outlines the issues without taking sides. Readers are invited to submit their own views on the necessity or otherwise for reform.

Key words

Restrictive covenants, non-compete clauses, post-employment restraints, employment contracts, labour mobility, innovation

* Professor of Law, University of Technology Sydney, Professor Emerita, The University of Sydney.

[1] Dr Leigh expressed views to this effect in a seminar/webinar, 'Unlocking Labour Mobility: Non-compete clauses and their Future in Australia' presented at the University of Technology Sydney Business School on 3 December 2024.

[2] For information on the review, visit the Competition Review website: https://treasury.gov.au/review/competition-review-2023/non-compete-clauses.

[3] See Joellen Riley, 'Sterilising Talent: A Critical Assessment of Injunctions Enforcing Negative Covenants (2012) 34(4) *Sydney Law Review* 617; 'Commodifying Sheer Talent: Perverse Developments in the Law's Enforcement of Restrictive Covenants' in William van Canaegem and Chris Arup (eds), *Intellectual Property Policy Reform* (2009, Edward Elgar, UK) 267-284; 'Who Owns Human Capital? A Critical Appraisal of Legal Techniques for Capturing the Value of Work' (2005) 18(1) *Australian Journal of Labour Law* 1-25; 'No poaching? Why Not? A Reflection on the Legitimacy of Post-Employment Restrictive Covenants' (2005) 19(1) *Commercial Law Quarterly* 3; 'Who Owns the Customers? A Reflection on Recent Cases on Post-employment Restraint Clauses' (2003) 17(2) *Commercial Law Quarterly* 3.

Prevalence of post-employment restraints

'There is growing international evidence that restraints of trade – and particularly non-compete clauses – are becoming increasingly prevalent. This evidence also suggests that despite benefiting some business, restraint of trade clauses are adversely impacting workers, other businesses and broader economic outcomes – through reduced wage growth, job mobility and access to skilled workers.'[4]

These observations sum up the concerns driving the Australian Government's Competition Review into the effect of restrictive covenants in employment contracts, and its search for appropriate reform. Evidence presented in the Issues Paper, and in a Working Paper prepared by former President of the Fair Work Commission, Dr Iain Ross, reveals that restrictive covenants purporting to stop workers from changing jobs or setting up their own businesses have become commonplace in many trades and occupations.[5] Restraints are not confined to the employment contracts of highly paid professional innovators and salespeople. Now, hairdressers, childcare workers and yoga instructors are commonly required to sign commitments that they will not work for any competing business after resignation. The research suggests that employers are seeking to enforce these restraints. The Issues paper cites threats of legal proceeding being brought against cleaners, nurses and hairdressers earning less than $45,000 per annum, and one incident of a legal suit being filed against a teenager on the minimum wage. To understand how such practices have developed, we need to understand how the law has developed in Australia in recent decades.

Legal enforcement of non-compete clauses

If we could go back hundreds of years, to the time of blacksmiths and cobblers, we would see that the common law in its wisdom developed a doctrine making illegal any contract term that was contrary to the public interest in free trade. Masters who secured promises from their apprentices that the apprentice

[4] Competition Review, *Non-competes and other restraints: understanding the impacts on jobs, business and productivity Issues Paper*, April 2024, Australian Government Treasury, 2 ('*Competition Review Issues Paper'*).
[5] See Iain Ross, *Non compete clauses in employment contracts: the case for regulatory response,* TTPI Working Paper, ANU, 2024.

would not set up shop in a nearby village after completing their training found that the courts would not enforce such contracts, because these agreements were against the public interest in two respects: they hindered free competition in goods and services, and they stymied the ability of able-bodied workers to support themselves and their families.[6]

This doctrine making illegal restraints of trade was modified after the decision in *Nordenfeldt v Maxim Nordenfeldt Guns and Ammunition Co*,[7] concerning the sale of an international arms dealing business. The purchaser who paid an exceptionally high price for the business was able to enforce the seller's covenant not to compete for a period of years, on the basis that the restraint was a reasonable measure to protect the buyer's legitimate interest in maintaining the value of the business goodwill captured in the purchase price. Since *Nordenfeldt*, the principle allowing the enforcement of restraints that go no further than necessary to protect a legitimate interest has expanded, and allows the enforcement of restraints even in employment contracts, where there has been no payment of consideration for the restraint, beyond the promise to pay a regular salary to the worker.

Over time, the kinds of interests that are considered 'legitimate' for protection have expanded from truly valuable trade secrets, to all manner of types of commercial information, and employers' claimed interests in securing their relationships with customers and staff. Many businesses (one suspects the hairdressing salons in particular) take the view that they 'own' their customers, so that their staff should not be able to service those same customers should the employee choose to leave to work elsewhere. Strictly speaking, the law does not recognize any 'ownership' of customers – customers enjoy a liberty to give their business to whomever they please – though there can be copyright in a list of customer names and contact details. The law is prepared to recognize that employees who are the 'face' of a business may develop such relationships with customers that they can be restrained (by an appropriately worded restraint) from soliciting those clients for a period of time after leaving

[6] For a more scholarly account of the history of restraints see Harlan M Blake 'Employee Agreements Not to Compete' (1960)73 *Harvard Law Review* 625.
[7] [1894] AC 535.

employment. Once upon a time, such restraints would be valid for a short amount of time, long enough for the former employer to recruit a replacement and contact clients to assure them of continued service – perhaps a matter of two or three months. Over time, longer restraints have been enforced. A relatively recent development has also allowed employers to enforce restraints preventing departing employees from offering employment to their former colleagues.[8]

The need for proof of a legitimate interest protectable by a restraint begs an important question: if the restraint protects, say, the confidentiality of the employers' commercial secrets, or its relationships with customers, why can the order made by the court not be limited to an order not to use that confidential information, or not to solicit those clients? Why should restraints be enforced by stopping the former employee from taking the new job? Arguably, they shouldn't, because pure non-compete clauses remain illegal.[9] Unfortunately, a case decided some years ago in the United Kingdom determined that the easiest way to ensure that a former employee did not break a promise to keep commercial secrets, would be to keep them out of the marketplace entirely for a period of time, and this has become a regularly cited precedent in Australia.[10] (The law has always tended to favour employers' interests in these kinds of cases.)

Arguably, many of the restraints in the employment contracts of ordinary workers would not be enforceable if challenged in a full court hearing of the legitimacy of the restraint, either because they do not protect a legitimate interest of the employer, or because they are excessive, in the territory they purport to cover or their duration. Unfortunately, many restraints are enforced in practice because workers cannot afford to defend legal proceedings. The mere threat of legal proceedings is sufficient to persuade the employee to comply with the employer's demand. This is what is described as the 'in terrorem' effect of contractual restraints. Employees are afraid to challenge them and may even decide

[8] See *Cactus Imaging Pty Ltd v Peters* [2006] NSWSC 717, [55]; *Quantum Services & Logistics Pty Ltd v Schenker Australia Pty Ltd* [2019] NSWSC 2, [55].
[9] See *Marlov Pty Ltd v Murat Col* [2009] NSWSC 501.
[10] See *Littlewoods Organisation Pty Ltd v Harris* [1977] 1 All ER 1472.

not to seek or accept fresh employment at all, because they cannot afford to lose their income while waiting out the period of a restraint. Even those who do seek to defend an employer's enforcement action may be effectively forced to comply with an illegitimate restraint, because interlocutory injunction applications are decided without full argument of the merits of the case, and only on the basis of whether there is a 'serious question to be tried' and whether the balance of convenience favours grant of the injunction.

The amount of time that it generally takes to proceed from an interlocutory injunction to a full hearing means that injunctions have expired by the time of full hearing. The interlocutory injunction has already done the practical work of keeping the worker out of the marketplace, without the employer ever having to justify the legitimacy of the restraint under full scrutiny of the law.

Injunctions

The ease with which injunctions are granted in these cases is part of the reason that the law has developed in favour of employers seeking to restrain the movement of staff. Another old case – older even than *Nordenfeldt* – is regularly cited for the proposition that an injunction can be granted to enforce a negative covenant (a promise not to do something) in an employment contract. *Lumley v Wagner*[11] concerned an opera singer (a niece of the great composer) who was contracted by her agent to sing for a season at Her Majesty's Theatre in London. During the term of that three month contract, she was invited to sing at Covent Garden and proposed to break her contract with Her Majesty's Theatre to enable her to do so. The Lord Chancellor of the day, Lord St Leonards, made an exception to the general rule that the appropriate remedy for breach of a contract is damages, and an injunction cannot be ordered to enforce a contract for personal services (all employment contracts are contracts for personal services). He granted an injunction to hold Miss Wagner to her agent's contract, saying that he was not forcing her to sing for Her Majesty's but only enforcing her implied negative promise, not to perform for

[11] (1852) 1 De GM & G 604; 42 ER 687.

anyone else during the term of her contract. The injunction only lasted for a matter of weeks, but this case has subsequently been relied on as the precedent for allowing the enforcement of many longer restraints by injunction, so that injunctions have now become the 'normal' and by no means exceptional remedy in these cases.

Another orthodox principle applying to the grant of injunctive relief has also been eroded in employment restraint cases, particularly in New South Wales, in recent years. Once it was the case that an injunction would be granted only when damages would be an inadequate remedy, and subject to the court's discretion. That discretion would not be exercised in the face of competing considerations, such as hardship to the defendant. In New South Wales, however, one judge has said:

> I am of the view that the mere fact that the injury to the plaintiff is slight or non-existent is insufficient to justify declining an injunction on discretionary grounds; so also is the mere fact that enforcement of the injunction would occasion considerable hardship to the defendant.[12]

So an employer can obtain an injunction against an employee even if it will cause significant hardship, without providing any benefit to the employer whatsoever (any student of Economics 101 would recognize that as an inefficient result).

In employment cases, the employee often presents with some kind of hardship. An injunction stopping them from taking up the new job may have serious financial consequences for themselves and their families. See, for example, the case of *John Fairfax Publications Pty Ltd v Birt*,[13] where a man with a dependent wife and children was subjected to an injunction preventing him from taking up fresh employment for six months. His pleas of financial hardship were met by the harsh ruling that he was 'the author of his own misery' in signing the employment contract in the first place. This raises the question of contracting practices, and whether employees fully understand the restrictions they have agreed to when they sign their original employment contracts.

[12] *Otis Elevator Co Pty Ltd v Nolan* [2007] NSWSC 593, 30 (Brereton J).
[13] [2006] NSWSC 995.

Contracting practices

These days many if not most employment contracts are in a standard form, provided by the employer's lawyers or the in-house legal department, and drafted to protect the employer from all manner of potential risks, real or imagined. Restrictive covenants have become 'boilerplate' terms in the contracts of all manner of ordinary workers. They are rarely negotiated, if indeed they are read at all. It is not uncommon for people to receive and return a signed copy of their employment contract *after* they have accepted an oral offer of a job, and even after beginning work. The rationale for enforcing these covenants because they are seriously made voluntary contracts is unrealistic, in the face of common experience. And yet judges often cite the latin phrase 'pacta sunt servanda' to justify a finding that those who sign contracts must be held to their terms, whether or not they read the contract or understood the implications of their signature.[14]

Over time, these legal developments have led us to the position faced by the Competition Review now. There is concern that the widespread use of restraints has contributed to problems of low wage growth, low job mobility, and a lack of support for innovation in Australian business. Start-up enterprises can be hindered in their attempts to hire experienced staff if potential talent is routinely restrained from taking up new positions by onerous restraints.

The Issues Paper circulated in 2024 sought submissions to better understand the economic impacts of restraints and how they operate in our legal system before developing any responses.

Reform possibilities

The government has not yet foreshadowed any particular measures to address these concerns. One of the questions they may need to consider is whether restraints are best treated as a competition law issue, suitable for regulation in the Competition and Consumer legislation, or whether they should be regulated as a workplace law issue.

[14] See *Seven Network (Operations) Ltd v James Warburton (No 2)* [2011] NSWSC 386, [3].

A complete ban on the use of all restrictive covenants in employment contracts, such as has been proposed in some states of the United States of America, is likely to face considerable resistance in Australia.[15] Advocates for the use of restraints by established businesses claim that enforceable restraints allow businesses to invest in training and talent development. It will be interesting to see whether submissions to the Review provide reliable empirical evidence of this benefit.

Many of the arguments used by employers in favour of maintaining the enforceability of restraints are most persuasive when applied to highly paid staff who possess intimate knowledge of the enterprise's intellectual property rights, business strategies, and supplier and customer relationships. Those arguments rarely make sense for shop-floor staff in modestly paid occupations. One solution to the problem of the excessive use of restraints in the contracts of ordinary wage earners would be to outlaw the use of restraints for employees whose incomes fall below a high-income threshold.

A provision making non-compete restraints unenforceable in employment contracts, in the same way that pay secrecy clauses are now unenforceable, would be one way of addressing the spread of restraints in the contracts of employees whose wages and conditions are governed by awards and enterprise agreements made under the Fair Work Act 2009 (Cth).[16] Attempts by employers to use pay secrecy clauses attract civil penalties. Attempts by employers to threaten enforcement of non-compete clauses might also attract civil penalties, to curtail any risk that illegal clauses might still be used 'in terrorem' despite their illegality.

Businesses operating in a tight labour market understandably prefer to use restraints to attempt to keep their staff. There have even been suggestions that agricultural employers have sought to deal with labour shortages by using non-compete clauses in contracts with seasonal fruit pickers to prevent them from taking up better paid jobs at other orchards.[17] Such restraints would not be enforceable because

[15] See *Competition Review Issues Paper*, 24-25.
[16] *Fair Work Act 2009* (Cth) ss 333B-333D.
[17] See Ross (n Error: Reference source not found).

they do not protect any legitimate interest of the employer. They are pure non-compete clauses, which remain unenforceable at law, although they may be practically effective due to their 'in terrorem' effect on naïve workers.

Employers could however use incentives to keep staff, such as improved pay and conditions. There are already all sorts of benefits built into our system of employment entitlements that favour long service, such as long service leave, enhanced notice of termination and severance pay entitlements upon redundancy. Employees are not easily tempted to leave good, well-paid jobs. They are inclined however to leave jobs where they have been treated poorly, and to look for better jobs with higher pay, more attractive benefits, and more interesting work and career prospects. Employers who wish to keep staff could resort to providing valued benefits, and a good working environment, rather than be permitted to capture unhappy staff by restraints limiting their departure.

As the discussion of the legal principles above illustrates, much of the harm caused by the enforcement of post-employment restraints is due to the easy grant of interlocutory injunctions. If the normal remedy for breach of a restraint was damages, only awarded where the employer seeking to enforce a restraint could prove significant damage to their business as a consequence of the misuse of truly confidential information, departing employees might be free to move on to greener pastures, burdened only with the obligation not to exploit any of their former employer's property. This would seem to be a fairer solution, and one which respected the employers' claims to protection of their legitimate interests without allowing them to reduce competition in labour markets. As this solution would require the reversal of a significant body of common law jurisprudence, it would also require legislative intervention.

It remains to be seen whether the current government, or any future government, takes any action to address the rising prevalence of restraints in employment contracts. If any firm reform proposals are tabled, it will be interesting to see the response of those speaking on behalf of employers. The business

sector has mixed interests in the issue. Established enterprises that already hire all the talent they need may have an interest in maintaining the status quo, but new enterprises seeking to expand and innovate may see a benefit in liberating the labour market from the dampening effects of restraints that discourage talented workers from considering new endeavours and changing jobs.

Declaration of interests

Nil.

Joellen Riley Munton
December 2024