Employment

# Interested in the blue pencil: Restrictive Covenants in the Supreme Court

Posted on 08 July, 2019 by | Andrew Burns

As the only implied obligation in a contract of employment to survive post-employment is the duty of confidence, any other regulation of the conduct of an ex-employee must be done by an express post-termination restrictive covenant. Such covenants place restrictions on the freedom of the ex-employee to work and trade, and generally have the effect of limiting competition, so they are strictly regulated by the law. In essence, a covenant which is in restraint of trade must be reasonable to be enforceable. The covenant must be carefully drafted and carefully construed to ascertain whether it is reasonable or unreasonable - enforceable or unenforceable.

In *Tillman v Egon Zehnder* [2019] UKSC 32 the Supreme Court restated some basic principles of law applicable to restrictive covenants, approving Victorian legal concepts cited in Nordenfelt v Maxim Nordenfelt Guns & Ammunition Co [1894] AC 535. The general rule is that all restraints of trade are contrary to public policy, and therefore void unless 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.*"

A restrictive covenant in a contract between an employer and an employee has to be construed like any other contract by ascertaining the intention of the parties from the words of the contract against the factual matrix. A strict interpretation should be given to restrictive covenants as they are regarded as clauses drafted with particular care ( *Prophet plc v Huggett* [2014] IRLR 797). A court may not easily find that something has 'gone wrong with the language' and thus restrictive covenants are not readily amenable to judicial reinterpretation. A court should therefore not too urgently strive to find within covenants, which are on their face too wide, implicit limitations which could justify their imposition.

In *Tillman v Egon Zehnder* the question was about the meaning of 'interested' in a non-competition clause – the most powerful weapon in an employer's arsenal of restrictions. Ms Tillman agreed that she would not "*directly or indirectly engage or be concerned or interested in any business carried on in competition with any of the businesses of the Company or any Group Company which were carried on at the Termination Date or during the period of 12 months prior to that date and with which you were materially concerned during such period."*

The issue was whether being "interested in any business" included any shareholding in a company, because that would be unreasonably wide. Many non-competition covenants expressly exclude a minor shareholding from the scope of the restriction – but this one did not. The employee said that as this restriction was unreasonably wide, the whole clause was unenforceable. The employer said that preventing a shareholding was not a restraint of trade at all, "interested" did not mean the holding of shares in a business and, in any event, the words "or interested" could be deleted by a judicial 'blue pencil' thus rendering the clause enforceable. The employer lost on the first two points, but the clause was saved by the third.

The employer's first point was an unattractive technical argument that although the non-competition covenant fell squarely within the doctrine of restraint of trade, the prohibition on shareholding within it did not. Lord Wilson gave this short shrift. He noted that this was a carefully drawn clause which tried to find as great a protection as possible without being unreasonable and was in a contract which the parties expressly agreed was a reasonable restriction. A controlling

shareholding is plainly within the doctrine of restraint of trade and even a minor shareholding was often valuable remuneration for a senior executive. Preventing someone holding shares could therefore be a restraint of trade.

Lord Wilson then turned to the meaning of being 'interested' in a business. He noted that the company could not have it both ways: it could not sensibly argue that the word "interested" covers a large shareholding but not a small shareholding. It is all or nothing. The company therefore contended for nothing.

The Supreme Court endorsed the modern approach to construction which is to resolve ambiguities so as to render covenants valid where possible. A court should adopt a commercial and realistic approach to construction which accorded with parties' intentions. There is a balance to be struck between giving a clause an extravagant meaning and giving it a meaning which is artificially limited.

*TFS Derivatives Ltd v Morgan* [2005] IRLR 246 suggested that if there is an element of ambiguity with two possible constructions, one of which would lead to a conclusion that the covenant was in unreasonable restraint of trade and unlawful, and the other to the opposite result, the court should adopt the latter construction on the basis that the parties are to be deemed to have intended their bargain to be lawful and not to offend against the public interest.

Lord Wilson tweaked this approach approving cases which said that if the contract was "capable" of being read in two ways, the meaning which would result in validity might be upheld "even if it is the less natural construction". The search was for a "realistic" alternative construction which might engage the principle. The Company's argument foundered on its inability to identify such a realistic alternative meaning other than a shareholding. The Company's argument that the words might be mere surplusage did not find favour when "interested" had often been used in contracts and held in case law to indicate a shareholding. The Supreme Court held "interested" means a shareholding.

So, the validity of the clause depended on whether the unreasonably wide and unnecessary prohibition on Ms Tillman being a minor shareholder of a competitor could be deleted from the clause by means of a 'blue pencil'. Covenants must be construed in their context, if necessary implying restrictions to exclude fanciful scenarios. However, the court cannot read down a clause in an effort to render it reasonable and enforceable. If only a discrete phrase within a particular covenant is held to be unreasonable, individual words or phrases may be severed or 'blue-pencilled', provided that what is left makes independent sense without the need to modify the wording and that the sense of the contract is not changed.

This conventional approach was endorsed by the Supreme Court. After a masterful survey of the historical roots of the judicial blue pencil and its treatment in other jurisdictions, Lord Wilson overruled the rather confused reasoning in *Attwood v Lamont* [1920] 3 KB 571 that severance was only possible if it was in effect a separate restriction. He approved the three-stage approach in *Beckett Investment Management Group v Hall* [2007] ICR 1539:

a. The unenforceable provision must be capable of being removed without the necessity of adding to or modifying the wording of what remains - the 'blue pencil' test. It is inherent in the word severance itself, which involves cutting things up and does not extend to adding things in. Lord Wilson said that the 'blue pencil' criterion is an appropriate brake on the ability of employers to secure severance of an unreasonable restraint customarily devised by themselves.

b. The remaining terms continue to be supported by adequate consideration. That will usually be the case as a claimant employer who asks the court to sever and remove part of a covenant made by the defendant employee is in no way proposing to diminish the consideration passing from himself under the contract such as is necessary to support the obligation which he seeks to enforce. This second requirement can therefore usually be ignored.

c. The removal of the unenforceable provision does not so change the character of the contract that it becomes not the sort of contract that the parties entered into at all. That criterion was reformulated by Lord Wilson as being "whether removal of the provision would not generate any major change in the overall effect of all the post-employment restraints in the contract".

It is for the employer to establish that its removal would not do so. The focus is on the legal effect of the restraints, which will remain constant, not on any changing significance for the parties. Application of the severance principle to Ms Tillman's restraint covenants was therefore straightforward. The words "or interested" were capable of being removed

from the covenant without the need to add to or modify the wording of the remainder. Removal of the prohibition against her being “interested” would not generate any major change in the overall effect of the restraints.

The Court of Appeal’s concern that the holding of shares in a company would mean that she was still “indirectly…concerned” in it was rejected by Lord Wilson. To be ‘concerned’ in a business a person needed to work in it or have some other active involvement. If concerned meant merely a shareholding, that would deprive ‘interested’ of any value and conventional principles of construction required value to be attributed, if possible, to each word of an agreement.

The covenant was thus upheld, but in inviting submissions on costs, reference was made to the unfair burden of the Courts having to clear up legal litter in contracts by use of the blue pencil. Adding an almost dramatic twist to the final line of the judgment, Lord Wilson said that although the Company had won, the costs order might be a sting in the tail. The blue pencil may be used to save an unreasonable restrictive covenant, but the employer may have to pay the costs of doing so.

Andrew Burns QC specialises in complex commercial, employment and industrial disputes, particularly injunctions. He has featured in some of the leading appellate cases in insurance law and trade disputes in recent years, and advised parties in some of the highest profile trade disputes in the UK.