

EFFECT OF THE REMUNERATION CODE ON THE RESTRAINT OF TRADE DOCTRINE

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Financial Disincentives to Competitors

1.1 Rather than risk contractual provisions prohibiting competition on leaving employment being struck down on an unlawful restraint of trade, Employers have on occasion attempted to circumvent the doctrine by introducing provisions which do not expressly bar competition but impose a financial penalty as a disincentive to competition. The courts have been, in general, astute to recognise such provisions as falling within the doctrine as much as express contractual prohibitions.

1.2 To give some examples:

(a) An agreement to pay a retiring employee a pension on terms that:

“You are at liberty to undertake any other employment or enter into any business except in the wool trade ...”

Held by the Court of Appeal that the term was an unlawful restraint of trade and because it was the sole consideration for the payment of the pension the employer did not have to continue payments of it even although the former employee was content to continue to comply with the restraint (see Wyatt v Kreglinger and Fernau [1933] 1 KB 793).

(b) Rules in employee pension schemes to the effect that:

“If in the opinion of the [trustees] any retired member [of the scheme] is engaged or employed in any activity or occupation which is in competition with or detrimental to the interests of [the employer] ... [the trustees] shall be entitled to cancel all his rights and benefits under these rules” (see Re Prudential

Assurance Co v Trust Deed, Horne v Prudential Assurance Co [1934] Ch 338 and Bull v Pitney-Bowes Ltd [1966] 3 All ER 384)

Held that the rules in question constituted unlawful restraints on trade but could be “blue pencilled” from the other scheme rules leaving former employees with an unconditional right to their pension benefits.

- (c) A contractual term in an employment contract providing for commission earned by the employee pre termination of his employment but due to be paid post termination to be payable if he had served a minimum ten years with the employer:

“provided that the agent’s entitlement to such commission will immediately cease if the agent enters into a contract of service or for service directly or indirectly with any [Business] involved in the selling of insurance or would be in breach of any part [of an express covenant restraining competition during the employment] were this contract still subsisting” [see Sadler v Life Assurance Co of Canada Ltd [1988] IRLR 388)

Held the proviso was an unlawful restraint of trade but could be severed from the remainder of the provision and because there was ample other consideration to support the payment of post termination commissions (not least the fact that the contracts on which they were payable had been secured by the employee before termination of his employment), those commissions remained payable notwithstanding the excision of the unlawful restraint.

- (d) A contractual term in a self-employed sales agent’s engagement making his entitlement to receive commission payable (in respect of work he introduced prior to termination) post termination of his engagement conditional upon his not, for a period of one year, setting up as an independent intermediary or being employed by any competitor of his former principal (Marshall v NM Financial Management Ltd [1995] 1 WLR 1461 upheld on appeal [1997] 1 WLR 1527). Held that the condition was an unlawful restraint of trade notwithstanding that it was not a synallagmatic contract but a unilateral contract in the form of a pre

condition but that it could be excised from the contract leaving ample consideration to support the post termination commission payments.

2. The rationale for applying the doctrine to financial disincentives

The Stenhouse Principle (Stenhouse Australia Ltd v Phillips [1974] AC 391)

2.1 In this case a clause in a settlement agreement terminating the employment of the respondent with an insurance broker provided that in the event that any client of the former employer within a period of five years from the termination date placed any insurance business (of the type transacted by the employer) with the departing employee, he would pay one half of any commission received from such transaction to the former employer.

2.2 Manifestly this provision did not prohibit the former employee from competing for the business of his former employer's clients but the Privy Council nonetheless held it to be an unlawful restraint of trade:

“whether a particular provision operates in restraint of trade is to be determined not by the form the stipulation wears but ... by its effect in practice ... The clause in question here contains no direct covenant to abstain from any kind of competition or business, but the question to be answered is whether, in effect, it is likely to cause the employee to refuse business which otherwise he would take or, looking at it another way, whether the existence of this provision would diminish his prospects of employment” (per Lord Wilberforce, Stenhouse Australia Ltd v Phillips *ibid* at 402F-H, *my emphasis*).

2.3 It follows, as a matter of principle, that any financial disincentive, whatever its guise, that might inhibit an employee from leaving his employment could fall foul of the restraint of trade doctrine.

3. Stenhouse disregarded

3.1 In 2004 a case emerged where the Stenhouse principle was not applied in relation to a provision which one might have thought fell squarely within Lord Wilberforce's dicta:

Peninsula Business Services Ltd v Sweeney [2004] IRLR 49. This case concerned provisions incorporated into a sales executive's contract of employment. The employee was entitled to a small annual salary but the bulk of his emoluments comprised commissions on services sold to customers. The rules of the commission scheme entitled the employee to payment of commission "at the end of the calendar month following that in which the business was conducted but only if the [employer] has received at least 25% of the fees from the client". If 25% of the fee were not paid at the end of the calendar month in which the business was conducted, then the employee was to receive the commission at the end of the calendar month following the calendar month in which 25% of the fee had been received.

- 3.2 The provisions complained of were rules of the commission scheme which provided that commission would only be paid if the sales executive was in employment at the end of the calendar month when the commissions would normally be payable and which provided:

"It is therefore an express contractual provision that an employee has no claim whatsoever on any commission payments that would otherwise have been guaranteed and paid if they are not in employment on the date when they would normally have been paid [commission]. Employees ... under a period of notice ... will be entitled to the appropriate commission payments payable at the end of each calendar month in question that falls within such a notice period."

- 3.3 The employee claimed he had been unfairly constructively dismissed. He claimed outstanding commission as a contractual debt alternatively as damages. Peninsula asserted that he was not entitled to the commission, however he put his case. At first instance the employment tribunal held, inter alia, that the provisions in question were an economic disincentive to leave the employment and were in unlawful restraint of trade purporting to apply Marshall (supra). Accordingly the employee was entitled to commission earned but not paid at the date of termination of the employment. The Employment Appeal Tribunal overruled that decision.

3.4 The EAT held that in Marshall the court had ruled that the only feature of the commission payment provision that was an unlawful restraint was the proviso that the employee did not work in competition with his principal. Another part of the contractual terms providing for the payment of the commission post termination was that the agent had to have worked for the principal for at least five years before he became entitled to post termination commission. This five year qualification period was held not to be an unlawful restriction. Consequently the EAT held that because there was no restriction in the Peninsula case on the former agent's liberty "to carry on his trade in such manner and with whom he might choose", the case was different from Marshall. Moreover, the EAT held, the five year "qualifying period" in the Marshall case before the agent was entitled to any post termination commission could be viewed as an economic disincentive to a termination of the agency agreement during that five year period but the courts in that case held that it was not invalid.

3.5 The Peninsula decision is a very curious one. First, insofar as it decides that a condition which does not expressly bar a person from working for whomever he wants or at any job he wants is not subject to the restraint of trade doctrine, then it runs counter to the very high authority of the PC (the advice given by Lord Wilberforce) in Stenhouse v Phillips (supra). Indeed, in Stenhouse the "profit sharing" arrangement necessarily implied a positive permission to the employee to work in competition with the former employer yet the PC held the arrangement to be an unlawful restraint. Stenhouse was not apparently cited to the EAT in Peninsula. Secondly, by contrast, the provisions in Peninsula entitling the employee to commission only if he remained an employee at the date payment of them fell due operated onerously, as the EAT recognised. In Peninsula, the employee received a base salary of only £8,500. During his first year he was guaranteed a bonus of £20,000 payable in monthly portions. Thereafter he was vulnerable if he left his employment to a "time lag" in receiving commission because of the stipulation that he could not receive commission until his employer received at least 25% of the payments due from a customer. The employer operated a system under which most clients paid for their services over a thirty-six month period. That meant that

25% of the fee was not received by the employer until the ninth month after the services had been sold and accordingly the employee was not entitled to receive his commission until the end of the tenth month following his having sold the services to the customer from which the fee to the employer was generated. In this case the employee lost some £21,000 of commission remuneration. Of this aspect of the case, the EAT stated (ibid, paragraph 26):

“Mr Cape who appeared for Mr Sweeney made much of the point that when Mr Sweeney signed the commission rule document, he did not know of the ten month time lag in the expected receipt of commission, a feature which, in the event of resignation, would potentially make [the relevant commission rules] particularly onerous. We of course accept the tribunal’s finding that he did not know this, and no doubt that feature made even more onerous what might anyway be regarded as an onerous clause. But we do not regard this as a feature which operated to exclude the case from the ordinary principle that a man who signs a contract is to be taken as agreeing to and as being bound by, its terms” (ibid, para 26, my emphasis).

Of course the EAT was right in its conclusion that a man is bound by a contract, even an onerous one, if he signs it without reading it (L’estrage v Graucob 1934 2 KB 394). What is impossible to understand, however, is why the EAT did not link what it held to be an onerous provision with the restraint of trade doctrine. It would have been simple (and correct) to conclude: (a) the doctrine applied to the commission rules (following Stenhouse); (b) the employer had a legitimate interest to protect in retaining good salesmen; but (c) the restraint to protect that interest (i.e. the economic disincentive to leave created by the loss of commission earned) was unreasonable because it is too onerous to deprive a man of nearly three-quarters of his annual remuneration, especially where he has done the work to earn it.

4. Good leaver/Bad leaver provision

4.1 Provisions which entitle departing employees to enjoy greater financial benefit, if having left they do not compete with the employer or which disentitle a departing employee to a financial benefit if they subsequently compete will, on the Stenhouse principle, be subject to the restraint of trade doctrine.

4.2 If, as I believe, Peninsula (supra) is wrong, employers cannot evade the application of the doctrine by avoiding the use in good/bad leaver provisions of express references to competitive activities. If, for example, financial benefits already “earned” under a contract but not yet paid are lost under a bad leaver clause which provides for such loss merely upon the voluntary resignation of the employee, then such a clause should be subject to scrutiny under the restraint of trade doctrine to determine whether it is reasonable or not.

4.3 It should be noted that the application of the restraint of trade doctrine to bad leaver provisions depriving employees of private equity houses from an entitlement to carried interest is far from straightforward, not least because it may involve the scrutiny not merely of an employment contract but a matrix of agreements made with limited partnerships (see the obiter observations of Lord Glennie in Greck v Henderson Asia Pacific Equity Partners [2008] C60HZ at paragraphs 84-89).

5. Not all financial disincentives will be an unlawful restraint of trade

5.1 The Stenhouse principle does not render automatically unenforceable any provision depriving an employee of a financial benefit if he leaves his employment (or conversely rendering it a condition of receiving a benefit that he remains in employment). Stenhouse merely holds that economic disincentives imposed on employees if, in substance, constituting an inhibition on his moving to another employer, are subject to the restraint of trade doctrine. Certain disincentives are unlikely to be found unreasonable under that doctrine. In the Marshall case (supra) the agent had to have been engaged for five years before he became entitled to post termination commission. That was held to be a valid provision although in substance it would act as a disincentive to terminating his engagement during the first five years.

5.2 Similarly a provision in a discretionary bonus scheme requiring an employee to be in employment with the employer at the date when it is paid would not be an unreasonable

restraint at last where the scheme is not based wholly upon performance but includes a loyalty element as well.

5.3 It is obvious, however, that deferring the payment of bonuses and imposing a condition of being in employment on the date of payment could constitute an unreasonable restraint if the deferral is lengthy. In this respect it makes no difference whether the deferral is of a cash payment or the vesting of a share option. In a case in the High Court of Ireland (Finnegan v J&E Davy [2007] IEHC 18), Smyth J held that a bonus scheme under which bonuses earned in the course of one year were pro rated for payment over three (including the year of earning) constituted a restraint of trade. He further held that it was an unlawful restraint of trade in that bonuses already earned would be lost because the employee had to be still in employment with the employer on the deferred dates in order to receive the full bonus. It is true that the facts of this case were exceptional but it illustrates the danger of provisions of whatever kind that seek to tie employees to employers using financial benefits as sticks or carrots.

6. The impact of the remuneration code

6.1 The restraint of trade doctrine springs from public policy which hitherto, at least in employment cases, favours the free movement of labour in any particular market. Restraints on that free movement have to be justified by reference to legitimate private interests (e.g. confidential information protection as the protection of client connections). But under the doctrine, even legitimate private interests have to yield to the public interest if it is engaged. The cases discussed above demonstrate that the doctrine is all pervasive and cannot be avoided by crafty draughtsmanship. It is the triumph of substance over form.

6.2 I venture to suggest, however, that the remuneration code will change the whole landscape of the doctrine of restraint of trade as it applies to employees regulated under it. The Code now represents a fundamentally different public policy towards financial institutions and their employees. The proposed new rules are designed to eliminate or

at least reduce “excessive and imprudent risk taking” by financial institutions to which “inappropriate remuneration structures” have been a “contributory factor”. Thus the SFA proposes inter alia:

“a new rule (SYSC 19.3.7R) ensuring that a firm’s remuneration policy does not encourage risk taking that exceeds a firm’s tolerated level of risk” (FSA consultation paper, July 2010, paragraph 3.35)

“a new rule (SYSC 19.3.8R) to ensure that a firm’s remuneration policy is in line with its business strategy and long term corporate values .. the assessment of an employee’s remuneration should be based on longer term performance ...” (ibid, para 3.36, my emphasis)

“new rules (SYSC 19.3.22R) on risk adjustment to state that firms must take into account current and future risks when determining variable remuneration” (ibid, para 3.50).

6.3 Employees can no longer complain of variable remuneration provisions which have the effect in substance of tying them to existing employers for lengthy periods before receiving remuneration that they may have earned in any given year of employment. Moreover variable remunerations must be used to tie an employee into his employer’s business future. At least 50% of any variable remunerations must consist of an appropriate balance of shares or equivalent ownership interest or share linked or equivalent non-cash instruments and where appropriate capital instruments (Rule 19.3.45R). A firm must not award, pay or provide a variable remuneration component unless a substantial portion of it which is at least 40% is deferred over a period which is not less than three to five years vesting no faster than on a pro-rata basis. The deferral component rises to 60% when the variable remuneration is £500,000 or above (Rule 19.3.46).

6.4 Moreover:

(a) “Non financial performance metrics should form a significant part of the performance assessment process and should include adherence to effective risk management and compliance ...” (Rule 19.3.35, my emphasis). Query, therefore, whether loyalty can be a significant element in any variable remuneration; and

- (b) A firm must ensure that the assessment of performance is set in a multi-year framework in order to ensure that the assessment process is based on longer term performance and that the actual payment of performance-based components of remuneration is spread over a period which takes account of the underlying business cycle of the firm.

6.5 The revised remuneration code provides an employer who hitherto may have been in difficulties justifying the postponement of variable remuneration payments or the vesting of share options or equivalent under the Restraint of Trade Doctrine with the unassailable argument that he is not offending public policy thereby, he is actually implementing it.

Other impacts on competition for employees

7. To date, attempts by employers in the financial sector to impose ties on the movements of employees to rivals, by providing for the loss of bonuses if they do, have not in fact had much impact. A rival will offer an employee guaranteed bonuses to cover any loss of bonus he may suffer on moving. This will no longer be possible: see Rules 19.3.38-19.3.41.

A final thought

8.1 Historically, the Restraint of Trade Doctrine has been applied by the courts more rigorously in the case of employees than in, for example, partnerships or business sale agreements. Given, however, that now 50% of variable remuneration must consist of shares or equivalent interests or share linked or equivalent interests, can employers insert non-compete provisions in such share etc awards and argue that the restraints should not be judged on the basis that they are restraints imposed on employees but on the more generous basis of shareholders' agreements (see Systems Reliability Holdings v Smith [1990] IRLR 377).

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