

THE MOBILITY OF CREATIVE INDIVIDUALS, TRADE SECRETS AND RESTRAINTS OF TRADE

William van Caenegem¹

INTRODUCTION

Organizations provide the context, structures and complementary resources that allow creativity to thrive². Organizations also absorb and spread the uncertainty, costs and risks inherent in creative activity. But no matter how efficiently organizations are structured for creative activity, only individuals *actually* create new things. Individuals make connections, understand and overcome problems, have intuition and new ideas: no innovation in technology, no creativity in the arts can exist without a human mind at work. That is as inescapably true in the current age of organized, collaborative and systematic creative pursuit as it was in the age of heroic invention and creative genius³.

Certain conditions within an organization should maximize the potential for creative output of an individual with particular knowledge and abilities. But it is of course difficult to predict what organizational conditions will be most effective, both in a general sense or for any particular creative individual. One way to overcome this difficulty is to posit that all creative individuals will optimize their own potential for creation⁴. In other words, they will choose to work in an organization which they rationally perceive as providing optimal conditions for creativity.

Two further propositions then follow: first that sufficient freedom of choice and mobility between organizations for creative individuals will vindicate and reinforce those conditions within organizations that are conducive to creativity, to the

¹ © William van Caenegem, LL.M., PhD (Cantab), Professor of Law, Faculty of Law, Bond University. My thanks go to Professor Chris Arup of Monash University, Faculty of Business and Economics, for helpful comments on an earlier version of this article, and likewise to an anonymous reviewer.

² Under the term 'organization' I include commercial firms, universities, public sector institutions, arts organizations, foundations, associations and the like. Under 'context' I include the opportunity for social interaction and exchange; as Roberts J points out in 'The drive to codify: implications for the knowledge-based economy' (2001) *Prometheus* 19, 2, 110 knowledge is transferred by socialisation, education and learning. Firms are thus central to the processes of knowledge exchange by which and in which creativity occurs.

³ For a recent offering on authorship, see Zemer L, *The idea of authorship in copyright*, Ashgate (2005).

⁴ By creative individual I mean a person who is motivated to generate new things or ideas, be it in art, or science and technology. We here borrow, from the economics literature, the notion of the consumer as rational optimizer.

benefit of the organization as a whole. And, secondly, that observation of the internal conditions of organizations with the greatest concentration of creative individuals should reveal certain characteristics that can then be emulated elsewhere⁵.

But all this is conditional upon creative individuals having real and sufficient freedom to choose which organization to join, i.e. upon them enjoying sufficient job mobility⁶. Individuals' ability to select and join the organization which they judge will most effectively realize their creative potential should thus not be unduly fettered.

CONSTRAINTS ON CHOICE OF ORGANISATIONAL AFFILIATION

But before going on to address the legal fetters that form the main subject matter of this article, it is as well to acknowledge that a critical precondition for exercising a rational choice of organizational affiliation is access to information. In this context that means that creative individuals require access to information about the internal conditions of different organizations that interest them. But organizations that are engaged in creative work and produce and rely on new ideas and technologies tend towards secrecy and control of information, *inter alia* by reliance on IPR's⁷. To attract creative talent they should arguably take the opposite approach and tend towards *maximising* external supply of information, including about their internal knowledge base, resources and creative practices, so that creative outsiders have available the kind of information that would interest them.

However, other than to recognise that imperfect information supply to outsiders is a problem in terms of optimal choice, this particular sub-set of the "perfect

⁵ At a basic level this requires comparative study of creative organizations, to establish creative output levels. Peer-review, publication levels, patent intensity are useful measures of creative output, both in the arts and in science and technology. A further research task is then to identify the conditions of selected organisations that creative individuals find attractive; one such would undoubtedly be appropriability of creative output, and other knowledge and intangible asset – in other words, provisions in employment contracts, policies and the like that determine the extent of competing claims to intellectual capital between staff and firm. Research to identify trends in contractual provisions in Australia relevant to creative output is called for.

⁶ Much as consumer choice must be free for markets to operate efficiently, creative individuals must have the freedom to exercise choice as to the organization which they join or migrate to. This is not to ignore that choices of organizational affiliation are not mutually exclusive: individuals may operate simultaneously within different organizations – but some categories of organizational affiliation are more important than others; see further below.

⁷ Intellectual property laws encourage this secrecy to a perhaps unfortunate extent (eg, in patents law and in relation to trade secrets). The creative commons movement, and its equivalents in the industrial sphere such as 'open source biotechnology', are relevant here, in that they can result in a better balance between appropriation and free exchange of knowledge, certainly in the context of scientifically based innovation: as to the latter see Hope J, 'Open source biotechnology' at <http://opensource.mit.edu/papers/hope.pdf> (Thesis submitted for the degree of Doctor of Philosophy at The Australian National University). My thanks go to an anonymous reviewer for drawing attention to the connection between the topic of this article and the open source, creative commons critique of intellectual property.

information” conundrum goes beyond the scope of this article. Rather the focus below is on certain regulatory fetters or constraints on choice of organizational affiliation for creative individuals.

There are some further limiting parameters for this article. For one, creative individuals are not exclusively affiliated with a single organization; they may interact with many organizations simultaneously. In modern times the allegiance of individuals to particular organizations is fluid, complex and multiple⁸. Shorter term and multiple engagements on flexible legal bases are increasingly common, as the growth of outsourcing, even in creative pursuits, illustrates. However, I proceed on the basis that the most *crucial* organizational affiliation of the creative individual is centered on employment, i.e. a contract of service. The focus below is therefore on the regulatory framework that affects employment relationships, and in particular migration of creative individuals from employment in one organization to employment in another⁹.

It is as well to acknowledge that regulation is only one of many categories of constraints on creative individuals considering migration between organizations. For many practical and personal reasons, individuals may prefer to avoid the risks associated with change, even if conditions within a different organization are attractively high. Nonetheless, regulation is significant as it applies universally, and is amenable to modification by policy makers and regulators.

Amongst the many categories of regulation that modulate organizational affiliation, labor/employment law is the most obvious and direct. But in this article the focus is rather on how rules of intellectual property law might constrain individuals’ choice to migrate between organizations. These rules are particularly relevant to creative individuals: what knowledge, information and ideas they can freely migrate with is very significant for them¹⁰. IP law answers that question in various ways – one is to allocate property rights as between inventor and employer¹¹. But for tacit or unrecorded knowledge, contained in individuals’ minds and not amenable to property rights, the relevant rules are found in the law

⁸ Joellen Riley stresses these points, see ‘Who owns human capital? A critical appraisal of legal techniques for capturing the value of work.’ (2005) *Australian Journal of Labour Law* 18, 1.

⁹ The regulatory framework considered is largely based on Australian law, which is broadly consistent with the approach in other common law jurisdictions, but not in every aspect.

¹⁰ Or conversely the claims employers might be able to exert over their knowledge.

¹¹ By application of the statutory regimes that confer property rights and the common law rules associated with them. I note here that there is no international uniformity in the laws governing employee entitlement to statutory forms of IP. This area of law is not harmonized around international treaty provisions. For instance, in some jurisdictions employees benefit from statutory entitlements in relation to patented inventions made in pursuance of the terms of a contract of employment; in others, such as Australia, they do not. Where statutory entitlements exist, they vary between jurisdictions as well: eg a share of windfall profits-approach in the UK, but a uniform entitlement in Germany. My thanks to an anonymous reviewer for drawing attention to this international inconsistency.

of trade secrets (breach of confidence), contracts and restraints of trade (public policy), as is further explained below¹².

I posited above that freedom of organizational affiliation of creative individuals is beneficial because it results in the identification and reinforcement of conditions that optimise creative output¹³. However, in the commercial context there is a countervailing force that tends against mobility. The costs and risks resulting from the departure of creative individuals are considerable, most acutely so for R&D intensive or creative industries firms. They result from the time constraints, long delays, costs and uncertainty inherent in creative activity¹⁴. Firms that invest in genuine creativity in-house need a degree of certainty when assembling the complementary resources that will enable individual employees to create – the knowledge, the physical infrastructure, the finance, the people etc. The creative individuals they employ, with unique rather than generic skills, knowledge and aptitudes, are not easily substitutable. So firms have a natural inclination both to attempt to reduce the mobility of creative employees, and also to control or appropriate more of what those individuals know – their ‘tacit knowledge’, the human knowledge and experience in their minds¹⁵. Firms often see these as their own assets¹⁶, or their ‘intellectual capital’¹⁷. Recognition of the need for firm stability that enhances the planning of complex activities is certainly important. However, a regulatory framework that enhances individual mobility entails gains

¹² The issue we are tackling here is in effect another version of the hoary old chestnut of intellectual property laws’ perverse propensity to obstruct knowledge diffusion, at least in the short term. Rules that affect what knowledge, ideas and creative concepts and inspiration individuals can take with them to use in a different organisation are crucial. See also van Caenegem W, ‘Inter-firm migration of tacit knowledge: law and policy’, *Prometheus*, Vol 23, No 3 (2005).

¹³ Or, from an alternative perspective, individuals will affect organizational structures by exercising free choice of affiliation; positive organizational aspects will be reinforced where creative individuals are free to migrate to organizations of their choice.

¹⁴ Whether in R&D and commercialization, or in the arts, such as film production, publication or games development.

¹⁵ Some of which they have acquired in formal courses of study, but much while on the job; see further van Caenegem, above 11. Firms use various techniques to appropriate more of what individuals know, eg more extensive recording of information generated within the firm etc.

¹⁶ Riley rightly criticizes the unjustifiable expansion of this notion beyond traditional boundaries in firms: see above 8, at 1-4.

¹⁷ For the concept of intellectual capital, and its interaction with the narrower concept of intellectual property, see van Caenegem W, ‘Intellectual property and intellectual capital’ 48 *Intellectual Property Forum*, (March) 10-25, 2002, also available at http://epublications.bond.edu.au/law_pubs/20/. Whereas established forms of intellectual property are valued as assets on a balance sheet, the broader concept of intellectual capital also embraces knowledge assets that are not (internal business practices and processes), or that are but only as part of a broader category (eg external relationships under the heading of ‘goodwill’). Karl Sveiby is a significant pioneer in relation to the concept of intellectual capital: see <http://www.sveiby.com/TheLibrary/tabid/68/Default.aspx> for further bibliographical references; see also Edvinsson L & Malone M, *Intellectual Capital*, HarperBusiness (1999); Imparato N (ed) *Capital for our time: the economic, legal and management challenges of intellectual capital*, Hoover Institution Press (1999); Klein A, *The strategic management of intellectual capital*, Butterworth Heinemann 1999. My thanks to an anonymous reviewer for drawing attention to importance of situating the topic of this article within the broader debate about intellectual capital.

and losses from a firm-perspective: while employees may more readily transfer out, it is also easier to attract new employees to join the firm.

THE LEGAL FRAMEWORK

The rules of intellectual property law that most directly affect use of human knowledge and thus creative activity interest us most here¹⁸. What restraints does the law impose on individuals' rights to use all previously acquired know-how, tacit knowledge, intellectual experience and ideas once they have migrated to a new organisation? Conversely, what legal control can an ex-employer exercise over the know-how, knowledge, ideas, etc. absorbed on the job by an individual worker¹⁹? *Ex hypothesi*, the more control ex-employers can exercise by law over this essential fuel for creative activity, the higher the barriers to individual migration to a new organisation, and thus the more constrained the choice between organisations for a creative individual. If we accept that an individual is best able and motivated to determine which organisational affiliation will optimize her creative output, then these rule-settings require closer analysis.

The first distinction to be made is between contracts of service (employment) and contracts for services (below: outsourcing). As a general rule, different conditions prevail in relation to intangibles generated under each. The default position in contracts for services is that creators own the IPR's they generate²⁰. Under a contract of service, however, the default position is that the *employer* owns IPR's in duty-linked creative output²¹. Characterization of the contract is thus crucial.

Some creative activity is of an individualistic nature or occurs at a solitary stage of the creative process, and may well lend itself to outsourcing. But here we are concerned with creative activity, maybe more prevalent in science and technology, which requires continuous access to a broad spectrum of complementary resources: databases, proprietary IP, collegial interaction, laboratories, advanced computer technology, test results etc. Closer integration with the firm, and thus an employment relationship, is better adapted to this kind

¹⁸ As indicated above, the treatment of the law here is centered on Australian law. However, the legal situation in Australia is in my view broadly reflective of the position in other common law jurisdictions. Nonetheless, the legal position may still differ between jurisdictions; notably civil law jurisdictions commonly adopt a different approach to employees' misuse of trade secrets which may involve the criminal law and property principles to an extent that it does not in the common law world. My thanks to an anonymous reviewer for drawing attention to this fact; see also above 9.

¹⁹ In other words, will the law countenance 'tracing' of the source of an individual's knowledge to a previous employer?

²⁰ For instance, a commissioned architect owns copyright in plans, unless the commissioning contract expressly provides otherwise. Similarly a commissioned author or composer owns copyright in a manuscript, unless otherwise stipulated. However, this is not always the rule, see eg, the Designs Act which provides, by contrast with the Copyright Act that the commissioning party owns a design for the purpose of registration: Designs Act 2003 (Cth) sec 13 (1) (b); Copyright Act sec 35 (4).

²¹ This means that where a contract for services is mute, the principal cannot presume to 'own' resulting IPR's.

of creative activity²². Therefore, in this context the focus is on the position of the individual *employed* to create, rather than the conditions that prevail in contracts for services, increasingly important though the latter may well be²³.

In this area of creative and inventive activity of employees, leaving aside statutory property rights, two legal instruments are crucial. First, the equitable action for breach of confidence: how does it operate to restrict an ex-employee's ability to draw on her stock of knowledge, know-how and ideas in the service of a new employer or for her own account²⁴? Conversely, how does it allow a previous employer to exercise control over the stock of knowledge, know-how and ideas of the ex-employee?

Secondly, two types of contractual provisions in employment contracts: confidentiality clauses and general restraints of trade²⁵. The key issue here is to what extent courts will enforce post-employment restraints that serve the alleged purpose of protecting trade secrets. The judicial response to that issue will determine what limits there are upon an ex-employee's ability to draw on her tacit knowledge, ideas, know-how and experience after the termination of the employment relationship.

The residual legal position concerning employee knowledge centers on the distinction made in *Faccenda Chicken Ltd v Fowler* between a trade secret on the one hand, and general knowledge, know-how and experience on the other (below referred to as 'know-how')²⁶. The first always 'belongs' to the employer, but once the employment contract is terminated the employee can draw on the latter, free from restraint. Genuine trade secrets are thus governed by equitable obligations post-termination; but an employer can also choose to 'protect' them by express contractual provisions such as confidentiality clauses and general restraints of trade. However, knowledge, information, know-how, creative 'nous' that does not properly qualify as a trade secret is not amenable to 'protection' by contract, as is further explained below²⁷.

²² Furthermore, as indicated above employment tends to accommodate longer term planning, and also permits greater practical control over the processes and output of creative individuals.

²³ In other words, conditions or clauses concerning IPR's in contracts for services are also very significant; with the overall growth of such arrangements, it becomes more important to know the kinds of clauses and conditions that are commonly found in contracts for services. Not much information is publicly available, and it is an area that would merit further empirical research.

²⁴ Indirectly the action will also potentially restrict the new employer's access to such knowledge.

²⁵ See also van Caenegem W, 'Intellectual Property Law and Innovation', CUP (2006), Chapter 2, p 53 ff.

²⁶ [1987] Ch 117.

²⁷ This statement may have to be moderated somewhat; in reality some of the relevant jurisprudence is more accommodating to employers; about which further below; but see also Robert Dean, 'The law of trade secrets and private secrets', Thomson Lawbook Co (2nd ed 2002); Belinda Gray: 'Ocular Sciences: A new vision for the Doctrine of Breach of Confidence?' [1999] MULR 9; Anne Matthew, 'Ascertaining the Dimensions of a Reasonable Restraint of Trade in an Intellectual Property Context – An Analysis of the Australian High Court's Decision in *Maggbury v Hafele*', [2002] Mur UEJL; Adrian Brooks, 'The Limits Of Competition: Restraint Of Trade In The Context Of Employment Contracts' [2001] UNSWLJ 27; and Arthur Moses 'Restraints of trade in New South Wales' [2004] UNELJ 10. See also Riley, above 8; and

CONFIDENTIAL INFORMATION AFTER TERMINATION

The law regulates the obligations of employees in relation to knowledge and information differently during and post employment. During the term of employment, the (implied) contractual requirement of fidelity or good faith determines the proper use of all information (whether confidential or not) by most employees. Some executive or professional employees may be held to the higher standards of a fiduciary²⁸. But what interests us here is the position after termination of the employment contract, i.e. when an employee has chosen to move to a new organization. Then only an equitable obligation of confidence in relation to genuine trade secrets remains – i.e., not to divulge or use them in a manner inconsistent with the limited purpose for which the employee obtained or generated them. The broader duty of fidelity or good faith is no longer relevant.

In other words, after termination employees are free to do as they like with any acquired stock of knowledge that does not meet the legal standard of a trade secret (i.e. confidential information). Except for trade secrets and proprietary IP, they are free to draw on everything that they have previously learned, to advance themselves or some other organization. Of course, much employee knowledge that is critical to their creative endeavors *is* acquired on the job, rather than in formal courses of study. By observation and by doing, they assimilate the experiences and ideas of co-workers; they participate in discussions, seminars, joint experiments; they have access to databases etc. Employment thus both sharpens their creative aptitudes and inflates the stock of know-how on which their creativity feeds. And the amount that employees learn on the job and that is *not* amenable to appropriation by the employer (by legal means) is in fact vast; much of it is difficult to categorise, itemize or document and therefore not amenable to firm-appropriation by any legal mechanism. In this way, the law supports the critical function of firms in a knowledge economy as teaching and learning institutions for their employees. And as Riley rightly points out, employees increasingly seek out precisely those firms that can deliver this advantage²⁹.

The difficult task the law has to perform is to craft a test to distinguish between this type of free knowledge, and a firm's real and valuable trade secrets; the leading case in this regard is still *Faccenda* as indicated above. The law defines the standards to be met for information to qualify as a trade secret: it must have 'the necessary quality of confidence' about it, i.e. it must not be in the public domain; this is a relative concept rather than a requirement of absolute secrecy. Then the information must have been communicated in circumstances that warrant imposing a duty of confidence on the recipient; and thirdly there must be

van Caenegem W, 'Restraint of trade clauses in employment contracts' Vol 20 No 1 (2007) Australian Intellectual Property Bulletin 2.

²⁸ For an interesting example of the issues that arise in this context see *Victoria University of Technology v Wilson & Ors* [2004] VSC 33.

²⁹ See Riley above 8.

a breach, a use or divulging of information contrary to the purpose of the communication.

But there is a critical preliminary requirement: that the information claimed to be a trade secret belonging to the ex-employer is precisely identified³⁰. Ambit claims that do not substantively identify or catalogue the information concerned will be rejected by the courts, for two reasons. First, there is a risk of embarrassment if an injunction is granted³¹. Secondly, ambit claims of previous employers can operate anti-competitively, as no more than lightly disguised attempts to prevent competition after termination. Courts view such attempts with disquiet.

Faccenda and subsequent cases assert that free knowledge can include information that is not widely known outside the enterprise, or is even unique to the employer, where it does not meet the standard of a 'trade secret'³². As well as positing the basic need to draw a distinction between trade secrets and free information, *Faccenda* also stressed that the distinction must be made with particular care and discrimination, and subsequent cases have only reinforced that point. It must be practically possible to separate trade secrets from surrounding interconnected free knowledge. Ambit claims straying into the field of free knowledge must be resisted.

If it is recorded in some documentary form, the ex-employer will stand a relatively good chance of establishing what the trade secret is; that it is not in the public domain; that it can be separated from surrounding knowledge and information; and that an injunction can be fashioned that restrains its use without broader deleterious and unfair effects. But where knowledge exists only in the mind of an ex-employee, it is very difficult to satisfy all the requirements, not the least the requirement to clearly identify the alleged trade secret. The courts well understand the connection between control of knowledge or information, and competitiveness, as well as the public benefits flowing from free labor market participation by individuals with *all* their knowledge, skills, experience etc. This has inspired judicial vigilance in assessing employers' claims concerning misuse of alleged trade secrets. Courts continue to strip away the veneer of trade secrets protection from attempts at stymieing post-termination competition.

In the result an employer relying on the equitable action for breach of confidence alone to police the an ex-employee's use of knowledge will often find itself embarked upon a risky and uncertain venture, *a fortiori* where it is not in some documentary form. One potentially more attractive alternative is to seek to link a remedy sought post-termination to a contractual (i.e. related to the duty of fidelity or good faith) or fiduciary breach which occurred *during* the term of the employment. Cases since *Robb v Green* tend to distinguish between a person

³⁰ See eg, *Independent Management Resources Pty Ltd v Brown* (1987) VR 605 at 609.

³¹ That is, difficulty in complying with an order because it is unclear what exactly it relates to; see *O'Brien v Komesaroff* (1982) 150 CLR 310.

³² See eg, *Printers & Finishers Ltd v Holloway* [1965] RPC 239, Cross J.

who deliberately and surreptitiously collects or appropriates information, usually in some documentary form, and one who simply relies on recollection³³. Is the information something the employee could not avoid learning about, or something they deliberately sought out, collected or recorded? In the latter case either the court will more readily accept that what was so obtained, and can be clearly itemized, amounts to a trade secret, or it will reach back to fix on the unfaithful conduct of the acquisitive employee *during* employment to fashion a remedy. However, such an approach is usually predicated upon evidence of the existence and removal of some document or other physical record, and thus of limited application to know-how and individual knowledge existing only in the mind³⁴.

CONTRACTUAL CLAUSES DEFINING TRADE SECRETS

Predictably enough, employers seek to reduce the uncertainty occasioned by the residual rules by seeking to rely on contractual clauses that define 'trade secrets' very liberally. But this is not an easy road to hoe. Courts have repeatedly stressed the importance of clear demarcation and itemization if an order is to be granted enforcing confidentiality clauses, and, in any case, if a contractual clause is to work as the employer intends it will not be sufficient to rely upon abstract or general categories ('the trade secrets', 'the know-how', 'the confidential information'). But the alternative of actually identifying secret information in a contract signed at the outset of the term of employment is of course equally difficult, in particular in the case of a knowledgeable employee who is a creative worker in the field, actively concerned with garnering and generating new knowledge or creations. An effective and efficient *ex ante* identification enforceable after the period of employment is thus hard to fashion³⁵.

If recourse *is* had to broad and abstract categories in an employment contract, other difficulties arise: such abstraction might cause the clause to fail for uncertainty or because it amounts to an anti-competitive and illegal restraint of trade, as it restricts access to and use of a broad and ill-defined body of knowledge. In any case, if abstract terms are used, the judicial exercise of distinguishing real trade secrets from free employee know-how, with all its adherent unpredictability, is not avoided. So an employer drafting a confidentiality clause is caught 'between a rock and a hard place'. Not that this has deterred employers from inserting clauses that often amounts to little more than ritual incantations. Whether actually enforced or not, these may still have a significant chilling effect, which is an issue all in itself. As Young J suggests '[...] *it is extremely difficult to fashion a covenant which will exactly protect only that confidential information which is able to be protected and because it is difficult to*

³³ [1895] 2 QB 1.

³⁴ In any case, most such cases seem to relate to client and supplier details rather than creative or inventive pursuits (about which a little more later).

³⁵ Particularly so where an employee is actively engaged in creative activity, rather than simply being given access to trade secrets for the purpose of application rather than further development.

*predict what exact problem will emerge, it is acceptable for an employer with a legitimate interest to protect to restrain an employee from taking competing employment for a set period*³⁶.

The result is that the law relating to trade secrets and know-how does not impose significant constraints on individual inventive/creative workers' freedom to migrate to another organisation of their choice. The employee can integrate in a new organization and safely draw on all accumulated knowledge and know-how as long as this does not constitute a deliberately acquired or accumulated trade secret in documentary form. In terms of the first principle proposed above, that a creative employee must enjoy the necessary freedom to make an optimal choice of organizational affiliation, the law to this point thus seems favourable. As far as the countervailing principle is concerned, that the employer requires some predictability if it is to invest in creative activity, the law is not so conducive. That the employer can't do much to control future use of knowledge or 'know-how' derived from employment could act as a disincentive: why invest in accumulating a team of inventive researchers or creative artists and supply them with all the resources required, absorb all the inherent risks of innovation and creative activity, only to find that much of what any individual learns on the job can readily be taken to some new organization? But as said above, mobility cuts two ways: there may be little to restrain departing employees, but there is also little to restrain employees from joining up.

Furthermore, here covenants in restraint of trade enter into the equation to ameliorate the position of the employer, because the law has accepted that to protect genuine trade secrets, a general prohibition on post-employment competition can sometimes be warranted and enforceable. This is what Young J refers to in the quoted passage from *Kone Elevators* above.

COVENANTS IN RESTRAINT OF TRADE

Employers prefer to rely on such covenants, because they give broader protection and more comfort than equity or contractual confidentiality clauses. Nonetheless, such clauses are also beset by problems of uncertainty and other limitations.

The effect of broad covenants is not just to stop use of trade secrets, but also of know-how, i.e., the kind of knowledge, experience, ideas, concepts etc described as 'free knowledge' above. The law is averse to such general restraints on the normal operation of markets and therefore the default principle is that anti-competition clauses or general restraints of trade are contrary to public policy and void³⁷. Lord Mcnaghten in *Nordenfelt* said that: '[T]he public have an interest

³⁶ *Kone Elevators Pty Ltd v McNay* [1997] ATPR 41-563 at 43,821.

³⁷ Or some such term; as pointed out by Williams JA the terms illegal, void, unenforceable have all been used interchangeably: see *Cedar Hill Flowers & Foilage P/L v. Spierenburg* [2002] QCA 348 (6 September 2002) at [34].

*in every persons' carrying on his trade freely [...] – the point being that a covenant in restraint of trade prevents an ex-employee from competing not only with the ex-employer, but also with all other competitors*³⁸. However, the other limb of *Nordenfelt* is that in exception to the general prohibition, some restraints are enforceable, if they are reasonable, because they are limited in scope and serve a legitimate purpose; covenants must be 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.*³⁹. The onus of proving reasonableness is on the party seeking to enforce the covenant. It is now well established that in employment cases the protection of trade secrets is a legitimate interest that can be served by a general restraint⁴⁰. Megaw J put it in the following terms: *'... it is appropriate that a covenant restricting an employee from full freedom of taking other employment when he leaves the existing employment, should be included in the contract of employment where there is a real danger that the employee will in the course of that employment have access to and gain information about matters which could fairly be regarded as trade secrets...'*⁴¹. The restraint of trade doctrine is thus recognized as permitting judicial interference with freedom of contract so as to protect the public interest in competition. This tendency to interfere will be most pronounced in employment cases: *'[...] there is obviously more freedom of contract between buyer and seller than between master and servant or between an employer and a person seeking employment'* as Lord Macnaghten said⁴².

LEGITIMATE PURPOSE: PROTECTING TRADE SECRETS

Legitimate purpose lies at the heart of the reasonableness exception; only once such a purpose is established do issues of the nature of excluded business, term and geographical reach of a restraint come into play. In this context as well, employers cannot rely on ambit assertions that all businesses have secrets worth protecting to justify restraining post-term competition: they will have to establish that in their particular business there are such secrets to protect *and* exactly what they are⁴³. If the restraint attempts rather to prevent the use of public knowledge, or knowledge not properly referred to as a trade secret, it amounts to no more than a restraint on competition, offensive to public policy: thus, in *Triplex Safety Glass v Scorah* the restraint was *'[...] seeking to do what the law will not permit, because it is seeking to prevent him using general information as distinguished*

³⁸ *Nordenfelt v Maxim Nordenfelt Guns & Ammunition Co Ltd* [1894] AC 535 at 565.

³⁹ *Ibidem*.

⁴⁰ Another legitimate interest that can be protected by a general restraint is so-called trade connection: see van Caenegem W, above 24, Australian Intellectual Property Law Bulletin at 3.

⁴¹ See *Littlewoods Organisation Ltd v Harris* (1977) 1 WLR 1472 at 1485.

⁴² See *Nordenfelt*, above at 566.

⁴³ '[I]dentifiable objective knowledge constituting the employer's trade secrets' as it is put in the head-note to *FSS Travel & Leisure Systems Ltd v Johnson* [1999] FSR 505 (CA).

from special information such as secret processes or the like which are the employer's property'⁴⁴.

Some cases since Goulding J's trial decision in *Faccenda*, which proposed a three pronged categorisation, have accepted that the kind of information which '[S]o long as the employment continues, he cannot otherwise use or disclose [...] without infidelity and therefore breach of contract'⁴⁵ can also be protected by a restraint of trade. The significant case of *Wright v Gasweld Pty Ltd* adopted this approach, Kirby P and Samuels JA forming the majority⁴⁶. Kirby P offered his own slight modifications upon the classification offered by Goulding J, including a category of trivial or public information; information common to a particular trade or calling even if not publicly known; confidential information proper; and secrets that attract equitable protection whether or not there is a contractual agreement. His Honour then went on to adopt Goulding J's view (which had in fact incurred the disapproval of the Court of Appeal in *Faccenda* itself⁴⁷) that there is a category of information that is not a trade secret but is still sufficiently confidential to justify a restrictive covenant. He and Samuels JA concurred in rejecting the opinion on this point offered in *Faccenda* on appeal. Samuels JA agreed with Goulding J's categorization and view that information 'protected' by the duty of fidelity during employment but not strictly speaking a trade secret, can be protected by a restrictive covenant after termination.⁴⁸

If that were indeed the correct understanding of the law, it would have a significant adverse impact on the ability of an ex-employee to freely draw on all knowledge that is not strictly speaking a trade secret. It would allow the tentacles of restrictive covenants to reach into the zone of what most would consider legitimate competition. There has been some division in the cases since as to the standing of the three pronged approach, and as to whether a restrictive covenant is enforceable where the information at stake is not strictly a trade secret. Some have accepted it and others rejected it; for instance, Young J cites Gleeson CJ's more restrictive minority view in *Gasweld* with apparent approval, and also refers back to *Nordenfelt*, and to Megaw J's view in *Littlewoods Organisation v Harris*, which refers to 'matters which could be fairly regarded as trade secrets' as being appropriately protected by a covenant, and nothing else⁴⁹. Arguably, the views expressed in *Gasweld*, adapted from Goulding J's approach in *Faccenda*, when correctly viewed, are an aberration from which the courts are to some degree resiling, or with which they are at least very uneasy. In any case, most cases that have considered it concerned client details and such, rather than the kind of knowledge and know-how relevant to creative activity that interests us here.

⁴⁴ [1937] RPC 21 at 28.

⁴⁵ See *Faccenda Chicken v Fowler* [1984] ICR 589 at 598-599 per Goulding J.

⁴⁶ (1999) 22 NSWLR 317.

⁴⁷ At [1987] 1 Ch 137.

⁴⁸ This tends to discount the traditional tenet that information can be effectively confidential during employment, but not necessarily remain so after employment: a point that according to Gray is stressed by Laddie J in the *Ocular Sciences* case: see Gray, above 25, at p10.

⁴⁹ [1977] 1 WLR 1472 at 1485.

In terms of the balance between employees' ability to make an optimal choice of organizational affiliation, without regulatory restraints that serve no proper purpose or interest, and organizations' interest in predictability, the law relating to covenants strikes a balance that favors the employer, where it permits a restraint that protects a genuine trade secret. If it allows more than that, it goes too far. But at the very least the employer has the ability to avoid the uncertainty referred to above in relation to the *Faccenda* distinction; the employer will have been able to reduce the risks inherent in employee mobility and protect the investments made in innovation. To preserve a real trade secret, the employee will be proscribed, at least for a time, from choosing to join some other organisation even though it may offer a more attractive environment for creative endeavors.

PLACE, TIME AND ACTIVITIES TARGETED

However, the employer cannot use a restrictive covenant to protect a trade secret until it enters the public domain. A restraint must be reasonable in term, geography and excluded business to be enforceable. The covenant must be reasonable to serve the legitimate purpose identified, here to protect trade secrets; conversely a restraint which only protects against competition is never reasonable. As said in *Commercial Plastics v Vincent*: '*It is clear from the authorities that the plaintiffs were not entitled to impose a restriction which would prevent the defendant from using in competition with the plaintiffs the skill and aptitude and general technical knowledge acquired by him in his employment by the plaintiffs. The restriction has to be justified in this case as being reasonably required for the protection of the plaintiffs' trade secrets by preventing the defendant from disclosing confidential information imparted to him by the plaintiffs in the course of his employment*⁵⁰ for which *Herbert Morris Ltd v Saxelby* is called in aid. Trade secrets must be properly identified, and the question asked whether the restraint is reasonable to protect them, or too broad. For instance, in *Commercial Plastics* although there was confidential information to protect concerning a manufacturing process, the restraint was invalid as it was not limited to the industry in which information might be used and not limited to work similar to that carried out by the employee⁵¹. That, of course, does not mean that either when a restraint is found to be unenforceable, or where the reasonable period of the restraint has run out, an ex-employee is free to use trade secrets or divulge them to a new employer without restrictions. The equitable obligation of confidence remains as long as the ex-employee has not been released from it, either in express terms, or by the legitimate publication of the information. But as to know-how not amounting to a trade secret, the ex-employee is free at the end of the restraint period.

⁵⁰ (1964) 3 WLR 820 (Sellers, Pearson and Salmon LJ), at 826.

⁵¹ But a long and wide restraint might on the other hand be reasonable where contracts are of long duration, and the employer does business over a wide area, as in *Brightman v Lamson Paragon* [1914] 18 CLR 331.

In reality the judicial response to enforceability of general restraints has proven to be rather unpredictable. For one, the reasonableness standard is inherently vague; and furthermore, the factual circumstances of each business are infinitely variable. What may be reasonable for one employee in one line of business at a given time may be totally unreasonable for another in another business. This has led employers to draft step-wise restraints⁵². But there are drawbacks with such clauses – they are uncertain for the employer; and that uncertainty may also lead courts to find them unenforceable.

But in practical terms the uncertainty may tend to weigh more against the ex-employee than against the ex-employer. The costs of ignoring a possibly valid restraint may be so considerable that the ex-employee will be inclined to comply with a restraint at its widest, even when its validity is doubtful. This is a serious concern from the perspective of the creative employee who is prevented from migrating to a different organization on the basis of the dubious interests of her ex-employer. It might be addressed by having a clearer standard⁵³; or, more radically by finding that a restraint of trade to protect trade secrets is not enforceable in any circumstances, and letting equity in the guise of breach of confidence do the job. There is certainly a justifiable concern that common contractual practices relating to restraints of trade have negative consequences for the kind of individual mobility which was identified as desirable at the outset of this article.

CONCLUSION

Generally speaking creative individuals making unconstrained choices in a quest to optimize creative opportunity will identify the organizations that are most conducive to personal creative output. Thus, mobility of creative employees will encourage the most effective organizations to thrive and allow us to identify and emulate conditions that reinforce creativity elsewhere. The law should therefore not constrain such mobility unless there is a clear countervailing interest. One such interest is that of creative organizations in a degree of control over the creative output and capacity of employees. In its absence the incentive to invest in complementary resources that fertilize creative activity may be adversely affected.

Currently the law makes it difficult but not impossible for an employer to exercise control over the knowledge and know-how of ex-employees once they have chosen to migrate to a different organization. Where an employee has learned real trade secrets with commercial value, the employer can rely on equity to restrain their misuse. Admittedly the law is not overly encouraging of this kind of action, certainly where the knowledge concerned is not in documentary form (if it

⁵² Of which a good example can be found in the recent Queensland case of *Cedar Hill Flowers & Foliage P/L v Spierenburg*, above 34.

⁵³ Some amelioration of the law is to be found in statute; see eg the New South Wales legislation: *Restraints of Trade Act 1976* (NSW).

is then the contractual duty of fidelity or fiduciary duty may come into play), is inchoate (an idea not fully worked out) or exists only in the mind. Generally the employee can migrate with any knowledge that's entered their minds through normal processes (i.e. not processes focused on appropriating trade secrets). The law is also not overly encouraging of contractual confidentiality clauses, and generally they are beset by the various practical problems of drafting and enforcement explained above.

The law is rather more accommodating in relation to restraint of trade clauses. There are two main issues here: first, whether the protection of a trade secret is an interest that warrants the imposition of a general restraint of trade *at all*. Again, equity already provides remedies in relation to the misuse of 'real' trade secrets⁵⁴. In its inception in *Nordenfelt* the exception to the illegality of restraints related to preservation of goodwill. In such cases there is a far stronger argument favoring a general covenant – in its absence the bargain is impossible. Here that is not the case. Secondly, the restraint of trade seems a very blunt instrument to do the job of protecting a trade secret. Due to lack of predictability and imbalance between the parties, legally unenforceable restraints may often be observed in practice. Few employees would be prepared to run the risk of non-compliance and possible litigation, certainly in narrow sectors of the economy. It may also be that the consideration received renders employees more or less content to comply – but this decision obviously occurs without any regard for the public interest.

It might also be more acceptable for *particular* creative pursuits to be prohibited for a certain period, where they are directly analogous to the pursuits during employment, rather than *all* creative activity in a branch or sector of business or industry⁵⁵. It may be warranted to prevent an employee from rendering onto a new employer the fruits of artistic creation or research largely conducted elsewhere; but it is less acceptable to absolutely deny industry or society the benefits of individual creativity even for a limited term.

⁵⁴ In this regard, this statement of the Court of Appeal in *Woolworths* is cause for real concern: '*Merely because the law offers a degree of protection against the unauthorised use or dissemination of trade secrets by former employees does not mean that contractual protection is necessarily unreasonable or unavailable*': *Woolworths Limited v Mark Konrad Olson & Anor* [2004] NSWSC 372 at [38].

⁵⁵ In a manner analogous to the trade connection cases – see van Caenegem, above 24, *Intellectual Property Law Bulletin* at 3; for instance in relation to the further development of a concept, script or screenplay; or of a specified technology or research agenda.