Briefing Note: Restrictive Covenants, the Validity Principle and Severance After *Tillman v Egon Zehnder*

Mubarak Waseem

(1) Introduction

1. On 3 July 2019, the Supreme Court handed down judgment in *Tillman v Egon Zehnder* [2019] UKSC 32. The judgment is an important one in the employee covenant context. Its most significant effects are clarifying the 'validity principle', and lowering the test for severance, allowing an employer more readily to excise an offending part of post-termination restriction.

2. This briefing note summarises the judgment and addresses its practical significance.

(2) The facts

3. Ms. Tillman was employed as a consultant at Egon Zehnder Ltd. She was quickly promoted through the ranks and in 2012 become the joint global head of the company's financial services practice.

4. She was employed on a contract dated 2003, which contained a number of post-termination restrictive covenants, including a non-compete clause. As the Supreme Court noted at [51], the non-compete clause in Ms. Tillman's contract was a standard form restriction. Ms Tillman covenanted in clause 13.2.3 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.*"

5. Ms. Tillman's employment with the company came to an end on 30 January 2017, after which she informed the company that she intended to start work on 1 May 2017 as an employee of a competing firm. She contended that the terms of her non-compete clause were an unreasonable restraint of trade, and therefore void. On 23 May 2017, Mann J

at first instance granted an injunction ([2017] IRLR 828), which was set aside by the Court of Appeal ([2018] ICR 574).

6. By the time that the case reached the Supreme Court, there were three issues in play:

   (1) If Ms. Tillman was correct that the effect of the 'interested in' in the non-compete clause was to prohibit shareholding, was the non-compete in restraint of trade?

   (2) Was Ms. Tillman's construction of the words 'interested in' correct in any event?

   (3) Were the words 'interested in' capable of severance from the remainder of the non-compete clause?

7. Lord Wilson JSC gave the only judgment.

(3) Issue 1: Restraint of Trade

8. The company conceded that, if the doctrine of restraint of trade did apply to the non-compete clause, it would exceed the necessary protection of its interests and would therefore be in unreasonable restraint of trade. The question under Issue 1 was more fundamental: is a restriction on passive shareholding in restraint of trade?

9. Lord Wilson did not consider it necessary to define the outer limits of the doctrine (at [30]). He did, however, consider it "*curious*" that the company suggested that a single word in a clause might not be a restraint of trade where the remainder of a clause was. "*The company*", he considered "*cites no authority in which a particular word in a covenant which substantially falls within the doctrine has been held to fall outside it*" (at [31]).

10. This was supplemented by clauses 13.3 and 13.4. By the former, Ms. Tillman agreed that the provisions of the whole of clause 13 were fair and reasonable – a requirement that the clauses would only have to satisfy were the restrictions caught by the doctrine. By the latter, she agreed that any restrictions which were invalid would be severed. This represented a "*clear acknowledgment*" that the doctrine applied.

11. It is unclear why Lord Wilson derived support for the application of a doctrine that applies by operation of law (and by reason of public policy) by reference to the construction of the agreement. The position would no doubt have been that the doctrine applied even if the parties had agreed that: "the doctrine of restraint of trade does not apply to this contract".

12. However, Lord Wilson went on to consider that it was unsurprising that the company wished to protect itself against Ms. Tillman holding shares in a competing entity, which would enable her to influence its operations. Thus, "[i]*n substance as well as in form*", a prohibition on shareholding was a restraint on her ability to work for the duration of her covenants and was therefore a restraint of trade.

(4) Issue 2: Construction

13. The determination of Issue 2 is important not just in the employment context, but has a wider application, because the Supreme Court provided guidance on the proper application of the 'validity' or 'saving the document' principle, on which the company placed reliance.

14. The principle presumes that parties to a contract intended it to be valid, and allows the Court to prefer an interpretation that renders the contract enforceable and effective to one that renders it void.

15. The company contended that its construction of 'interested' (not being so broad as to cover a shareholding) was as equally plausible as Ms. Tillman's construction (that it did cover a shareholding). The company argued that, as its construction would lead the non-compete clause to be valid and enforceable, it should be preferred.

16. For a number of years, the term 'interested in' has been interpreted by the Courts as referring to a passive shareholding (see for the example the authorities cited by Longmore LJ in the Court of Appeal judgment in *Tillman*, [14]-[17]). The one bump in the road was the decision in *Tradition Financial Services Ltd v Gamberoni* [2017] IRLR 698. There, Foskett J relied on a provision of the contract which permitted a 5% passive shareholding during the course of employment. He considered that, construing the contract as a whole, 'interested in' in the covenant did not cover passive shareholdings (but that, alternatively, if there was ambiguity, the saving the document

doctrine would apply, and the provision would be read as not covering a shareholding). *Tradition* was to go the Court of Appeal, but did not.

17. Ms. Tillman's contract had a similar provision at clause 4.5, permitting her to hold a maximum of 5% of the total equity of a competing company during the course of her employment.

18. The company relied upon *Tradition* to suggest that its construction was correct, in particular in light of the validity principle.

19. Some authorities consider that the 'validity principle' requires that the enforceable and unenforceable constructions are equally plausible. Other authorities consider that the principle can save the enforceable construction in a wider range of circumstances, for example where there is only an 'element of ambiguity' or where the contract is merely 'susceptible' to the construction rendering it enforceable (see [41]).

20. The Supreme Court held (at [42]) that the validity principle is engaged at a point "*between these various descriptions*", and preferred Patten LJ's observation in *Tindall v Adda Hotels* [2015] 1 P&CR 5 at [32] that the search was for a "*realistic alternative*".

21. Lord Wilson then asked whether the company had provided a realistic alternative to Ms. Tillman's construction - he thought that it had not. At [49] Lord Wilson considered that the decision of Foskett J in *Tradition* departed from "*the obvious natural meaning of the word 'interested', such as had been recognised in our law for more than a century without dissent*".

22. At [52], the Supreme Court concluded that as the company was unable to propose a realistic alternative construction, the validity principle did not bite. The natural construction of 'interested' was that it covered a shareholding, whether small or large ([53]).

23. Another point relevant to construction can be taken from the end of the Supreme Court's judgment, although the point was dealt in the reasoning on severance (see below). It is that the word "concerned" will not cover a shareholding where the contract uses the words "concerned or interested" (at [90]).

24. At [90], Lord Wilson applied the principle of effectiveness and considered:

> "*But, were the word "concerned" to be construed so as to cover passive interest in a business such as that enjoyed by a shareholder, what value would be left to be attributed to the word "interested"? Nor is such an exercise in construing the word "concerned" undermined by the fact that the words "or interested" are to be severed and removed.*"

25. Thus, each word in a restrictive covenant must be given effect and have a content of its own, which is not affected by the severance of other words. The Supreme Court was not convinced by the suggestion that words in a restrictive covenant might be 'casual surplusage' (at [52]).[1]

26. Of course, the Supreme Court judgment leaves open the construction in other cases, in particular the case of a covenant which includes 'concerned' but not 'interested', which Lord Wilson recognised was "*clearly borderline*" ([90]).

(5) Issue 3: Severance

27. The most important aspect of the Supreme Court's judgment is its impact on the principles regarding severance. There are two issues in particular that are worth focussing on.

Parts of a single covenant can now be severed

28. That traditional approach to severance is that constituent parts of a single covenant cannot be severed. Only whole offending covenants can be severed, and the employer can rely on what remains.

29. In *Attwood v Lamont* [1920] 3 KB 571 (CA), Mr Lamont was prevented from being directly or indirectly concerned in the following trades:

[1] See *Freshasia Foods Limited v Jing Lu* [2018] EWHC 3644 at [52], where a non-solicitation covenants were described as "*probably casual surplussage* [sic] *of somewhat risk-averse drafting*".

> "*a tailor, dressmaker, general draper, milliner, hatter, haberdasher, gentlemen's, ladies' or children's outfitter at any place, within a radius of 10 miles of the employers' place of business*".

30. Younger LJ considered that excision of the offending parts of a clause could only take place where the covenant is: "*not really a single covenant but is in effect a combination of several distinct covenants*",[2] and that the covenant was "*in truth but one covenant for the protection of the respondent's entire business*" and, "*this covenant must stand or fall in its unaltered form*" (p.593).

31. In the Court of Appeal in *Tillman* [2018] ICR 574, Longmore LJ at [29] followed the strict approach illustrated in *Attwood*, considering that: "*it is well settled that parts of a single covenant cannot be severed*".

32. The waxing and waning of this strict approach is canvassed in the judgment of Lord Wilson at [66]-[79], but is now largely a matter of historical note. In the Supreme Court, the approach was changed.

33. Lord Wilson JSC revisited *Attwood*, and considered that it proved "*instantly controversial and ultimately unsatisfactory*" (at [83]). In the same paragraph, he continued:

> "*Why was the list of prohibited trades in the Attwood case one covenant but the list of prohibited areas in each of the Putsman and Scorer cases in effect more than one covenant? And, being a question noted in para 78(e) above,*[3] *why*

[2] See also p.577 *per* Lord Sterndale MR:

> "*it is still the law that a contract can be severed if the severed parts are independent of one another and can be severed without the severance affecting the meaning of the part remaining*".

[3] At [78(e)], Lord Wilson JSC noted that in *Freshasia Foods Limited v Jing Lu* [2018] EWHC 3644, the Deputy Judge had questioned (at [51]-[52] of that case) whether the 'separate covenants' requirement addressed the concern at hand.

should an unreasonable restraint of insignificant proportions fail to qualify for severance just because of its place in a single covenant?"

34. What is missing from the Supreme Court's judgment is an explicit statement that (1) the law has changed, and parts of the same covenant can be severed; or (2) that the law is the same, and "*engage or be concerned or interested in*" are separate covenants, such that they could be severed on an application of normal principles. In other words whether the conclusion that was reached was a change in approach or a question of construction.

35. Despite the absence of an explicit statement to that effect, it appears clear that the Supreme Court adopted the first of the two options. The judgment referred at multiple points to clause 13.2.3 as being "a" or "the" covenant. Therefore, *Attwood* is no longer good law and parts of a single covenant can now be severed.

The new 'major change' test

36. In assessing the test for severance, the Supreme Court used the three-step test laid out in *Sadler v Imperial Life Assurance* [1988] IRLR 388, followed in later cases such as *Beckett Investment Management v Hall* [2007] ICR 1539.

37. The criteria in those three steps were:

    (1) That the unenforceable provision is capable of being removed without adding to or modifying what remains. Lord Wilson noted that that test, known as the "blue--pencil" test, has operated capriciously, but nevertheless that severance could only take place where words were cut, not extended or added in (at [85]).

    (2) That the remainder of the provision continues to be supported be adequate consideration. This requirement has rarely been material in the caselaw, and the Supreme Court considered that in the usual situation this requirement can be ignored.

    (3) That the removal of the 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.

38. Though Lord Wilson considered that the third criterion has "*rightly been applied by our courts ever since* [*Beckett v Hall*]", he preferred to express the third criterion as:

> "*whether the removal of the provision would not generate any major change in the overall effect of 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 their perhaps changing significant for the parties and in particular for the employee*" (at [87] – my emphasis).

39. What constitutes a major change in the overall effect of the post-employment restraints in the contract? Little guidance is given in the judgment, but Lord Wilson considered that the answer when applied to *Tillman* was "*straightforward*" ([88]), and had no qualms about excising the words 'or interested' from the covenants in Ms. Tillman's Contract.

40. In reality, the effect of such an excision is quite wide. As we explored above, Lord Wilson had already considered that 'interested' referred to a shareholding, however small or large. So, with one stroke of the blue pencil, Ms. Tillman went from being prohibited from holding even one share in a competing business to being permitted to hold all of the shares in a competing business (so long, of course, as this shareholding was still merely an *interest*, rather than a concern or engagement). Surely, the company would have considered this to be a *major change* in Ms. Tillman's package of post-termination restraints.

41. Numerically, the position is equally stark. The Supreme Court excised 1/3 of the relevant restriction in the non-compete covenant. Lord Wilson noted that it if the words "concerned" also covered shareholding it would have appropriate to remove them too (at [90]), leaving just "engaged".

42. If the Supreme Court was content that severing 2/3 of the restrictive words in Ms. Tillman's contract was not a major change, the question arises what sort of excision would be an impermissible 'major change'? The Supreme Court was unhappy with the 'so change the character of the contract' test, but it is unclear whether the new 'major change' test is a test with a different character, or simply a test that is easier to satisfy.

43. Pending further clarification of the test in litigation that will inevitably follow, what is clear is that excision has now become easier for the employer in the standard form of covenant used in Ms. Tillman's case.

(6) Conclusion and take-away points

44. Before outlining its new 'major change' test, the Supreme Court warned at [82] that Court's must adopt a "*cautious approach*" to the severance of post-employment covenants. That statement sits uneasily with what the Supreme Court did next, which has undoubtedly widened the scope for employers to make severance fall-back arguments in restrictive covenant cases. Despite arguably being a 'major change' to the parties' agreement, the Supreme Court thought that severance of Ms. Tillman's (standard form) contract was "*straightforward*".

45. The judgment has important practical significance for post-termination covenants. In employee competition cases, employers usually have two weapons at their disposal in response to an unreasonably wide clause in restraint of trade. The first is the 'validity principle', which now requires the employer to provide a 'realistic alternative' construction the unenforceable construction for which the employee will contend. The second, of course, is severance. As a result of the judgment, severance will assume a much more important role than it has previously.

46. But *Tillman* is not one-way traffic. The Supreme Court has suggested that there may be a costs-based "sting in the tail" for employers who draft wide clauses with the hope of relying on severance. Lord Wilson accepted the analogy of the Deputy Judge in the *Freshasia* decision that the unreasonable parts of covenants are "legal litter". It remains to be seen whether the Court will order the employer to pay the clean-up bill.

MUBARAK WASEEM

Essex Court Chambers

mwaseem@essexcourt.com

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