



# A game of snakes and ladders

## Restraints of trade and ladder clauses

Ladder clauses have become an essential part of restraint of trade clauses in Australia. However, significant policy concerns with the use of these clauses bring into question their continued acceptance, particularly in contracts for employment. Recent decisions concerning restraints of trade and ladder clauses suggest that the courts' patience with clauses of this kind may be waning.



Restraint of trade clauses are a staple inclusion in many employment contracts, and for good reason. Employers have a legitimate interest in protecting their confidential information,<sup>1</sup> maintaining customer relationships<sup>2</sup> and preserving a stable and trained workforce.<sup>3</sup> In fact, one academic suggests that restraint of trade clauses are so essential to the preservation of an employer's interests that any lawyer who fails to advise on and draft an enforceable clause may well be considered negligent.<sup>4</sup> However, for a clause

that has such a ubiquitous presence in employment contracts, it is remarkable that their enforceability is so uncertain in any given circumstance. This is particularly true in jurisdictions (such as the ACT and Victoria) where the common law restraint of trade doctrine has remained largely unaltered by statute.

There are a number of reasons for this uncertainty, not the least of which is that a covenant in restraint of trade is considered to be 'contrary to public policy' and

therefore presumed to be void unless the party seeking to rely on its protection can demonstrate that it is 'reasonable' in the circumstances to protect the party's legitimate interests.<sup>5</sup> Specifically, the clause must be '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'.<sup>6</sup> This, in turn, touches upon the second key reason for the uncertainty surrounding the enforcement of restraint of trade clauses: the



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unenviable drafting exercise faced by a lawyer attempting to balance these competing imperatives. Failing to properly achieve this balance either means the employer's legitimate interests are not adequately protected or the clause is rendered void on the grounds of unreasonableness.

The task of drafting restraint of trade clauses is in no small way comparable to a high-stakes game of snakes and ladders. The lawyer tries to climb up the board to reach a point where all of the employer's interests are

adequately protected, but if the clause is drafted too ambitiously, the lawyer risks stepping on a snake and sliding back down into unenforceability. Unsurprisingly, resourceful lawyers have sought to craft a way around the pesky problem of balancing the need to adequately protect their employer client's interests, whilst seeking to minimise the risk of leaving the client without the protection of a restraint of trade—ladder clauses.

### Ladder clauses

Many practitioners will be familiar with ladder clauses, also known as cascading clauses. I will therefore keep my description of their operation brief.

Ladder clauses are a tool used to bypass the common law rule that courts cannot restate an unenforceable contractual clause in terms that would permit its continued operation.<sup>7</sup> This is achieved by harnessing the operation of the doctrine of severance. In short, ladder clauses are drafted in such a way so that the offending portion of the term can easily be severed from the contract, thereby preventing that portion of the term impugning the operation of the entire clause. Whether or not any particular restraint of trade term can successfully be severed from the contract in the event it is found to be unenforceable depends on the application of the "blue pencil test" (discussed further below).

Broadly speaking, restraint of trade ladder clauses operate in two different ways.

The first kind of ladder clause operates by creating a cascading series of reducing obligations.

Each particular obligation is only triggered when the more onerous restraint preceding it is held by the court to be unreasonable. In other words, the obligations in the clauses cascade down with ever diminishing burdens on the restrained party until the court finds that one of the clauses is reasonable and, therefore, enforceable. For reasons that I discuss below, ladder clauses of this kind run a relatively high risk of being held to be void on the grounds of uncertainty when compared the ladder clauses of the second kind.

The second kind of ladder clause, although on one conception they are not truly ladder clauses at all, purports to create multiple individual restraints operating *simultaneously*, with each restraint providing for a varying degree of burden on the restrained party. For example, one clause may create one obligation on the restrained employee to not work for a competitor for a period of three months, while another clause operates simultaneously to create a separate obligation to not work for a competitor for a period of six months.

Clauses of the second kind have a number of advantages over the first kind. Firstly, multiple clauses of this second kind operating separately are able to cast a net of obligations on the restrained party which is far wider than any individual term could achieve without a significant risk it would be found to be unreasonable. Secondly, separate clauses of this kind are more amenable to the "blue pencil test" for severance, allowing for unreasonably broad restraints to be removed from the contract with less risk of the whole clause being held to be invalid. Thirdly, courts have been more reluctant to find these sorts of clauses to be void for

uncertainty. This is because, properly drafted, clauses of this kind create multiple yet fundamentally distinct restraints that are, when viewed individually, ‘tolerably clear’ in each separate instance.<sup>8</sup> However, some recent decisions suggest that this second kind of restraint clause may increasingly become the subject of more critical judicial scrutiny.<sup>9</sup>

Ladder clauses are somewhat analogous to their counterparts in the game snakes and ladders. They permit a lawyer to climb quickly to the top of the board, ensuring that their client’s interests are entirely covered by the restraint of trade obligations while skipping untouched over the pitfalls of unreasonableness and unenforceability. Just like ladders in the board game, ladder clauses have become a legitimate and integral part of restraints of trade. However, unlike the game, the use of ladder clauses in restraint of trade provisions in employment contracts gives rise to policy questions about whether their operation is entirely fair on the restrained party.

These policy difficulties presented by restraints of trade formed through ladder clauses of both kinds are obvious.

Firstly, and notwithstanding the chequered application of the uncertainty doctrine, the real-world operation of these clauses creates significant practical uncertainty for the restrained party.

Secondly, clauses of this kind might encourage parties to litigate since the only way of certainly knowing which restraint will be considered enforceable is through the judgment of a court.

Thirdly, as Justice Dodds-Streeton noted in *IF Asia Pacific Pty Ltd v Galbally (IF Asia Pacific)*,<sup>10</sup> a restrained party may choose to comply with an unreasonable and therefore unenforceable restraint of trade in order to avoid litigation. This is particularly true for employment restraints given the significant resource imbalance that often characterises disputes between employers and employees.

In other words, the unclear practical application of restraints of trade contained in ladder clauses often, in practice, effectively give the restraining party the benefit of an unreasonable and legally unenforceable clause.

Given ladder clauses appear to have a practical operation that is *prima facie* contrary to the public policy considerations underpinning the restraint of trade doctrine, it begs the question of how the courts have reacted when confronted with restraints of trade arising out of ladder clauses. In general, it appears that the courts consider two questions. Firstly, is the ladder clause void for uncertainty? Secondly, is the restraint of trade more than what is reasonable to protect the legitimate interests of the party (that is, the employer) that benefits from the clause? Both of these questions represent a significant snake in the path of a lawyer drafting restraint of trade employing ladder clauses.

### Doctrines of severability and uncertainty

The doctrine of severability is essential to the operation of ladder clauses. While most contractual clauses operate on the presumption

they will be entirely enforceable, ladder clauses operate by accounting for, or even anticipating that, a portion of their terms may be held to be unenforceable. Where typically the consequence of even a part of a term being held to be unenforceable is the entire term being held void, ladder clauses avoid this outcome through the careful use of severability. In this way, ladder clauses are the legal drafting equivalent of design redundancy in engineering—the failure of a single component does not cause the collapse of the entire system.

So how does severability work? At common law, the test for whether an unenforceable term can be severed from the contract without undermining the entire clause (or, for that matter, the entire contract) is two-fold.

First, the court must be able to simply cut the offending words from the contract in order to remedy the provision. This is known as the “blue pencil test”—a reference to the metaphorical blue pencil a court uses to strike through the unenforceable portion of a contract. Essentially, the court can remove portions of the contract under the doctrine of severance, but cannot make additions or amendments to the contract. This is strongly related to the common law principle that the court cannot restate the contract for the parties in terms that would have been enforceable.

Second, the court must be satisfied that, once the offending portions of the contract have been struck out, the fundamental nature of the contract and the bargain between the parties is not altered. In other words, severance is available if ‘the elimination of the invalid promises

changes the extent only, but not the kind of the contract'.<sup>11</sup>

Justice Pembroke described this operation of the doctrine of uncertainty in *Seven Network (Operations) Limited & Ors v James Warburton (No 2) (Seven Network)*:

...the legal doctrine of uncertainty does not depend on mere complexity. Nor is opacity, obscurity or vagueness sufficient by themselves. There must be such a lack of clarity that the clause is unworkable: that it cannot be given effect in a meaningful way. Lord Denning once said that before a clause is held to be void for uncertainty, it must be "utterly impossible" to put a meaning on the words...<sup>12</sup>

So what is the intersection between the doctrines of severance and uncertainty in the case of ladder clauses?

Where a ladder clause has been framed too broadly, it appears that there is a far greater risk the court will hold the clause is void for uncertainty. The issue of what would be required to show that a ladder clause providing for a restraint of trade is void for uncertainty was discussed in *Hanna v OAMPS Insurance Brokers Ltd (Hanna)*. In that case, President Allsop commented that:

It may be that if multiple obligations on the same subject matter so conflict that a contracting party cannot know what it is to do, such clause, or the contract in which it is found, is uncertain and void.<sup>13</sup>

President Allsop's comments were later cited with approval by Justice Pembroke in *Seven Network*. In a

certain sense, the price paid by any lawyer drafting a clause that relies heavily on the doctrine of severability is an increased risk that a court will find that the clause is void for uncertainty. Specifically, it seems unlikely that a court would uphold a clause which effectively operates by presenting the court with a selection of available terms from which to choose an enforceable configuration on the basis of uncertainty.

In short, before a court is willing to uphold a ladder clause, it must be satisfied that the parties have, in fact, reached an agreement which is discernible from the contract. The reason for this is the fundamental

nature of contracts themselves as binding agreements between the parties which are enforceable by the courts. When ladder clauses are taken too far, the parties effectively leave 'to the court the task of making their contract for them',<sup>14</sup> thus triggering the application of the doctrine of uncertainty.

In relation to ladder clauses creating a restraint of trade, Justice Dodds-Streeton held in *I F Asia Pacific Pty Ltd* that the courts should adopt a stricter approach to the doctrine of severance.<sup>15</sup> This was adopted by Associate Justice Redlich in *Wallis Nominees (Computing) Pty Ltd v Pickett (Wallis Nominees)*, where he



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held, applying *IF Asia Pacific*, that Justice Dodds-Streeton:

...cautions against curial disentanglement of unreasonably wide clauses, recognising that they may act in *terrorem* by exposing employees to the threat of litigation. A too ready judicial willingness to save such clauses by severance would, as her Honour [Justice Dodds-Streeton] rightly observed, also reduce the sanction of invalidity otherwise applicable to employers who attempt to impose unjustifiably wide restraints. Where an employer has sought to burden its employees with a patently unjustifiable restraints, there should be a marked reluctance by the courts to allow the employer a belated revision of the conditions [through their severance from the contract]...<sup>16</sup>

This passage in *Wallis Nominees* was later cited with approval by Justice McDonald in *Just Group Limited v Peck (Just Group)*.<sup>17</sup>

However, despite these high profile warnings from the courts about the dangers posed by the doctrine of uncertainty to ladder clauses with an excessive reliance on the doctrine of severance, other courts have recently seemed reluctant to invoke the doctrine of uncertainty against ladder clauses in covenants in restraint of trade. With respect to the courts who have held these clauses to be sufficiently certain, their unwillingness to find that ladder clauses giving rise to restraints of trade are void for uncertainty has led to practical outcomes from judgments that are, at times, somewhat ironic.

For example, it was held in *Hanna* that the nine separate restraints found to be operating on the former employee, Mr Hanna, were each, 'when taken as individual covenants, all capable of being understood by the use of clear words and all ... capable of being complied with without breaching any of the others'.<sup>18</sup> Therefore, Mr Hanna was bound by multiple separate restraints each providing for a differing extent of obligation, ranging from 12 months in the metropolitan area of Sydney to 15 months Australia-wide. At least prior to that judgment, it seems hard to suggest that the operation of these restraint of trade clauses on Mr Hanna was anything other than uncertain. A similar result was also reached in *Seven Network*.<sup>19</sup>

These decisions highlight the difference between clauses that are legally uncertain for the purposes of the doctrine of uncertainty, and clauses that have an uncertain practical application such as those in *Seven Network* and *Hanna*, and, indeed, many other restraint of trades arising through ladder clauses. It is also worth noting that the courts in *Hanna* and *Seven Network* were deciding the issue in the context of the application of the *Restraints of Trade Act 1976* (NSW), which is significantly more forgiving towards restraint of trade clauses than the common law which operates in Victoria and the ACT untrammelled by statute.

However, when viewed from a policy standpoint, some might argue that this outcome is unsatisfactory. Nonetheless, one can venture the proposition that, provided individual restraints are sufficiently certain, it appears that the courts will uphold the bargains struck

between employers and employees, notwithstanding the uncertainty faced by the employee when they consider the multitude of alternative restraints in the contract. Given this, it is perhaps unsurprising that recent judgments have turned to the doctrine of unreasonableness in order to hold certain restraints clauses to be unenforceable.

## Unenforceability and unreasonableness

Again, at common law, covenants in restraint of trade are unenforceable on public policy grounds unless the party seeking to rely on the restraint can show it is reasonable to protect a legitimate interest. Broadly speaking, the principles relating to reasonableness of restraints of trade at common law were articulated by the Victorian Court of Appeal in *Wallis Nominees (Computing) Pty Ltd v Pickett* as (amongst others):

(a) A contractual provision in restraint of trade is, *prima facie* void.

(b) The presumption can, however, be rebutted and the restraint justified by the special circumstances of a particular case, if the restriction is reasonable by reference to the parties.

...

(c) So far as the parties' interests are concerned, the restraint must impose no more than adequate protection to a party in whose favour it is imposed. If the court is satisfied that the restraint confers greater protection than can be justified, there is no further issue of reasonableness.<sup>20</sup>

As I note above, ladder clauses are an enterprising way to avoid the full effects of this doctrine, provided they do not foul of the doctrine of uncertainty. Ladder clauses of the cascading kind avoid the impact of a restraint being found to impose ‘more than adequate protection’ by providing for a replacement restraint to apply in the event that the preceding clause is held to be unreasonable. In the case of ladder clauses consisting of multiple, simultaneously operating obligations, each individual restraint is to be viewed separately when asking whether the restraint that it contains is reasonable.

However, the recent decision of Justice McDonald in *Just Group* should stand as a warning to all employers who are not careful to draft ladder clauses that create clearly distinct obligations. When asked to uphold restraints clauses that purportedly created ‘50 discrete covenants’, in the absence of a clause expressly providing for this construction his Honour refused to do so. Instead, his Honour held that the clause should be construed as creating a single obligation which he later found to be unreasonable and, therefore, unenforceable.

Two things can be said of Justice McDonald’s decision in *Just Group*. First, given an express contractual statement to this effect, the court will in all likelihood interpret a ladder clause in a manner which either provides for the severance of unenforceable restraint or as creating separate obligations, each of which can be severed as necessary without impacting the others. This is good news for lawyers tasked with drafting restraint of trade clauses: it seems that ladder clauses will be upheld as a

legitimate drafting technique to skip over the snakes of unreasonableness and unenforceability.

Second, the *Just Group* decision also suggests that, given any opportunity by the words and circumstances of a contract, a court will not hesitate to give that contract an interpretation which undermines a ladder clause that it considers gives rise to an excessive restraint of trade. It therefore stands as a warning to lawyers not to take the task of drafting a ladder clause lightly. Failure to properly construct a ladder clause giving rise to a restraint of trade is likely to result in the unenforceability of the entire restraint of trade.

## Conclusion

Notwithstanding this warning shot across the bow in *Just Group* for clumsily drafted restraints of trade, the decision does little to address the policy concerns with the use of ladder clauses in restraints of trade.

In many ways, it looks as though these types of clauses operate as a direct link to the very top of the board for employers seeking to restrain former employees, while avoiding all the snakes carefully placed along the way by the courts to ensure no clauses are unreasonable.

In the absence of the consistent availability of the doctrine of uncertainty to remedy these concerns, and the continued inability of the doctrine of unreasonableness to render properly formed ladder clauses unenforceable, perhaps the time is ripe for legislative intervention in this area to remedy these issues in common law only jurisdictions.

In the meantime, however, lawyers tasked with drafting restraint of trade clauses should be careful to ensure they do not give a court any excuse to hold their restraint provisions unenforceable.

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## Endnotes

1. *Just Group Ltd v Peck* [2016] VSC 614, [7].
2. *Arthur Murray Dance Studios Inc v Witter* 105 NE 2d 685 (Ohio CP, 1952).
3. See, eg, *Cactus Imaging Pty Ltd v Peters* [2006] NSWSC 717, [43]-[56]; *Aussie Home Loans v X Inc Services* [2005] ATPR 42-060.
4. Neville Rochow, ‘Toward a Modern Reasoned Approach to the Doctrine of Restraint of Trade’ (2014) 5 *Western Australian Jurist* 25, 27.
5. *Nordenfelt v Maxim Nordenfelt Guns and Ammunition Company* (1894) AC 535, 565 (Lord Macnaghten).
6. *Nordenfelt v Maxim Nordenfelt Guns and Ammunition Company* (1894) AC 535, 565 (Lord Macnaghten); see also *Amoco Australia Pty Ltd v Rocca Bros Motor Engineering Co Pty Ltd* (1973) 133 CLR 288, 307 (Walsh J).
7. *Peters Ice Cream (Vic) v Todd* [1961] VR 485, 490.
8. *Hanna v OAMPS Insurance Brokers Ltd* [2010] NSWSC 267, [17].
9. *Just Group Ltd v Peck* [2016] VSC 614.
10. *I F Asia Pacific Pty Ltd v Galbally* (2003) 59 IPR 43, [201].
11. *McFarlane v Daniell* (1938) 38 SR (NSW) 337,345 cited in *SST Consulting Services Pty Ltd Reison* (2006) 225 CLR 516.
12. *Seven Network (Operations) Limited & Ors v James Warburton (No 2)* [2011] NSWSC 386, [37].
13. *Hanna v OAMPS Insurance Brokers Ltd* [2010] NSWSC 267, [12].
14. *Peters Ice Cream (Vic) v Todd* [1961] VR 485, 490.
15. *I F Asia Pacific Pty Ltd v Galbally* (2003) 59 IPR 43, [201].
16. *Wallis Nominees (Computing) Pty Ltd v Pickett* (2013) 45 VR 657, [110].
17. [2016] VSC 614, [65].
18. *Hanna v OAMPS Insurance Brokers Ltd* [2010] NSWSC 267, [11].
19. [2011] NSWSC 386, [40].
20. *Wallis Nominees (Computing) Pty Ltd v Pickett* (2013) 45 VR 657, [14].