

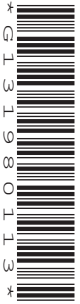
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A2 GCE LAW

G156/01/RM Law of Contract Special Study

PRE-RELEASE SPECIAL STUDY MATERIAL

JANUARY AND JUNE 2013



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G156 LAW OF CONTRACT

SPECIAL STUDY MATERIAL

SOURCE MATERIAL

SOURCE 1

Extract adapted from *Anson's Law of Contract*. 29th Edition. Beatson, Burrows & Cartright. Oxford University Press. 2010. Pp 396–399.

The common law does not favour agreements that prohibit or restrain a person in the exercise of a lawful trade, employment or profession. It protects the right of individuals to work and prevents them from disabling themselves from earning a living by an unreasonable restriction by the doctrine of restraint of trade. ...

There are statutory and common law controls over anti-competitive agreements. The statutory controls are contained in Articles 101 and 102 of the Treaty on the Function of the European Union and the very similar provisions introduced by the Competition Act 1988. 5

At common law the control is exercised by the doctrine of restraint of trade. ... An agreement in restraint of trade has been defined as 'one in which a party (the covenantor) agrees with any other party (the covenantee) to restrict his liberty in the future to carry on trade with other persons not parties to the contract in such a manner as he chooses'. This definition is adequate provided it is not applied too literally. In one sense, all commercial contracts restrain trade; for when one person binds another by contract, say to sell a piece of furniture, the seller's future ability to deal lawfully with that furniture with anyone not party to the contract is restricted. Yet ordinary commercial contracts are clearly not invalid. The issue is to determine which agreements are 'in restraint of trade'. 10
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Two categories of agreement have long been recognized as 'in restraint of trade'. First, agreements between employers and employees, whereby employees promise not to set up business on their own account on leaving the employers' service or to enter into employment with a rival firm. Secondly agreements between the buyer and seller of a business together with its goodwill, where the seller promises not to carry on a business which will compete with that of the buyer. 20

Apart from these types of agreement, there is no definitive way of determining whether or not an agreement is in restraint of trade. ... Lord Wilberforce has said: "The doctrine of restraint of trade is one to be applied to factual situations with a broad and flexible rule of reason ... the classification must remain fluid and the categories can never be closed." (*Esso Petroleum v Harper's Garage* 1968) ... 25

All restraints of trade, in the absence of special justifying circumstances, are contrary to public policy and ... void. ... A restraint can only be justified if it is reasonable (a) in the interests of the parties and (b) in the interests of the public. 30

SOURCE 2

Extracts adapted from *Nordenfelt v Maxim Nordenfelt* [1894] AC 535 HL.

Mr. Nordenfelt, original owner of a leading international arms manufacturer, sold his business in 1886 for £287,500. The business was transferred in 1888 and combined with a similar company owned by Mr. Maxim and became 'Maxim Nordenfelt'. The contract of sale including a clause stating that Mr. Nordenfelt could not for 25 years 'engage ... either directly or indirectly in the trade or business of a manufacturer of guns, gun-mountings or carriages, gunpowder explosives or ammunition or in any business competing or liable to compete in any way with that for the time being carried on by the company". Mr. Nordenfelt argued that the clause was void for being in restraint of trade.

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Both the first instance court and the Court of Appeal held that the clause was in restraint of trade. Maxim Nordenfelt appealed to the House of Lords but their appeal was unanimously dismissed.

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Lord MacNaughten:

In the age of Queen Elizabeth [I] all restraints of trade, whatever they were, general or partial, were thought to be contrary to public policy, and therefore void ... In time, however, it was found that a rule so rigid and far-reaching must seriously interfere with transactions of every-day occurrence. Traders could hardly venture to let their shops out of their own hands; the purchaser of a business was at the mercy of the seller; every apprentice was a possible rival. So the rule was relaxed. It was relaxed as far as the exigencies of trade for the time being required, gradually and not without difficulty, until it came to be recognised that all partial restraints might be good, though it was thought that general restraints, that is, restraints of general application extending throughout the kingdom, must be bad. Why was the relaxation supposed to be thus limited? Simply because nobody imagined in those days that a general restraint could be reasonable, not because there was any inherent or essential distinction between the two cases. ...

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The true view at the present time I think, is this: The public have an interest in every person's carrying on his trade freely: so has the individual. All interference with individual liberty of action in trading, and all restraints of trade of themselves, if there is nothing more, are contrary to public policy, and therefore void. That is the general rule. But there are exceptions: restraints of trade and interference with individual liberty of action may be justified by the special circumstances of a particular case. It is a sufficient justification, and indeed it is the only justification, if the restriction is reasonable – reasonable, that is, in reference to the interests of the parties concerned and reasonable in reference to the interests of the public ... That, I think, is the fair result of all the authorities. But it is not to be supposed that that result was reached all at once. The law has changed much ... It has become simpler and broader too. It was laid down ... that the Court was to see that the restriction was made upon a good and adequate consideration, so as to be a proper and useful contract. But in time it was found that the parties themselves were better judges of that matter than the Court, and it was held to be sufficient if there was a legal consideration of value; though of course the quantum of consideration may enter into the question of the reasonableness of the contract.

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SOURCE 3

Extract adapted from *Atiyah's Introduction to the Law of Contract*. 6th Edition. Stephen Smith. Clarendon Press. 2005. Pp 218–222.

Like restraints on personal liberty, [restraint of trade clauses] are regulated because it is thought that they may unduly restrict the freedom of the individual concerned. Such regulation is essentially paternalist – unreasonable restraints are thought to harm the interests of the restrained parties – but ... the courts do not hesitate to act paternalistically when they believe an important freedom is being curtailed, particularly if there are reasons to think the normal bargaining process may fail to adequately protect this freedom. This latter concern has long been raised in connection with covenants in restraint of trade, especially post-employment covenants, although the explanation nowadays is not so much that the affected party had no choice in the matter but that such covenants are often poorly understood and their impact underestimated. ... [They are also] often attacked on the basis that they unduly restrict the free flow of labour and goods on which a market economy depends. ...

Essentially, the question is the extent to which the law should interfere with the freedom of the contracting parties to do business in such a way as to limit or restrict competition. Broadly speaking, the traditional attitude of the courts was to leave the parties to use their own methods of conducting business, even if this was likely to lead to the creation of monopolies, unfair competition ... The influence of economic theories, and in particular of *laissez-faire*, can be seen in many important cases. ... In modern times, however, the courts have taken a more active approach to agreements in restraint of trade. ...

In deciding whether a restraint is reasonable, the courts have long taken the view that regard must be had to the 'interests' which the restraint is designed to protect. The general rule is that such clauses are valid if, but only if, they are no wider than is reasonably necessary to protect the legitimate interests of the promisee. The nature of these interests differs according to the type of case.

SOURCE 4

Extracts adapted from *Mason v Provident Clothing & Supply Co Ltd* [1913] AC 724 HL.

Lord Moulton:

[T]he critical question which the Court ought to address itself to in a case such as this ... is as follows: are the restrictions which the covenant imposes on the freedom of action of the servant after he has left the service of the master greater than are reasonably necessary for the protection of the master in his business? 5

The nature of the employment of the appellant ... was solely to obtain members and collect their instalments. A small district in London was assigned to him ... and outside that district he had no duties.

Such being the nature of the employment, it would be reasonable for the employer to protect himself against the danger of his former servant canvassing or collecting for a rival firm in the district in which he had been employed ... but I can see no further or other protection which he could reasonably demand. [The restrictive covenant in this case] prohibits the appellant from entering into a similar employment within 25 miles of [London] for a period of three years ... such an area is very far greater than could reasonably be required for the protection of his former employers. 10 15

It was suggested in the argument that even if the covenant was, as a whole, too wide, the Court might enforce restrictions which it might consider reasonable ... My Lords, I do not doubt that the court may, and in some cases will, enforce a part of a covenant in restraint of trade, even though taken as a whole the covenant exceeds what is reasonable. But, in my opinion, that ought only to be done where the part so enforceable is clearly severable ... It would in my opinion be *pessimi exempli* if, when an employer had exacted a covenant deliberately framed in unreasonably wide terms, the Courts were to come to his assistance and ... carve out of this void covenant the maximum of what he might validly of required. ... [T]he hardship imposed by the exaction of unreasonable covenants by employers would be greatly increased if they could continue the practice with the expectation that, having exposed the servant to the anxiety and expense of litigation, the Court would in the end enable them to obtain everything which they could have obtained by acting reasonably. It is evident that those who drafted this covenant aimed at making it ... penal rather than protective ... that they hoped by means of it to paralyse the earning capacities of the man ... and were not thinking of what would be a reasonable protection to their business, and having so acted they must take the consequences. 20 25 30

SOURCE 5

Extract adapted from *Treitel, The Law of Contract*. 12th Edition. Edwin Peel. Sweet & Maxwell. 2007. Pp 507, 515–519.

So long as there is an interest meriting protection, some restraint can be validly imposed, but [the draftsman must use precise language and not draw it too widely.] For example, in *Lyne-Pirkis v Jones* (1969) a covenant in a partnership agreement between doctors in *general practice* provided that a retiring partner could not (within certain limits of time and space) “engage in medical practice”. The court here refused to construe those words so as to refer only to general practice and held the covenant invalid as it prohibited practice even as a *consultant*. On the other hand, in *Home Counties Dairies Ltd v Skilton* (1970) a covenant in a milk roundsman’s contract provided that he should not serve or sell “milk or dairy produce”. It was argued that this would prevent him from serving cheese as a grocer’s assistant, but the court refused to invalidate the covenant as the parties clearly did not intend it to have this meaning. ...

The original tendency of the common law was to regard exclusive dealing arrangements as valid. ... The older authorities must now be read subject to a line of cases concerned with the validity of “solus agreements” between oil companies and [petrol stations]. The leading case (*Esso Petroleum v Harper’s Garage*, 1968) concerned solus agreements made in respect of two garages. One agreement was to last for four and a half years, the other for 21 years. The House of Lords held that the solus agreements were within the restraint of trade doctrine; that the four-and-a-half-year agreement was valid; but that the 21-year agreement was invalid as it was unreasonable and contrary to the public interest. ...

In the *Esso* case Lord Pearce distinguished between “those contracts which are in restraint of trade and ... those which merely regulate the normal commercial relations between the parties and which are therefore free from the doctrine.” ... However, Lord Wilberforce reserved the powers of the courts to subject even “accepted” contracts to scrutiny in the light of changing social or economic conditions or of special features in individual transactions. Later decisions have, in particular, made it clear that a contract is not taken out of the restraint of trade doctrine merely because it is in standard form and contains only terms that are usual in that type of transaction (*Watson v Prager*, 1991).

Where an exclusive dealing ... contract is subject to the doctrine of restraint of trade, the usual requirements [of suitable interest and reasonableness] must be satisfied. ... The reasonableness of the length of restraint may depend upon the type of contract concerned ... in the *Esso* case [a 21-year restraint was struck down but on different facts in a different case (*Alec Lobb Garages v Total Oil*, 1985) a 21-year restraint was upheld.]

SOURCE 6**Extracts adapted from *A Schroeder Music Publishing Co Ltd v Macaulay* [1974] 3 All ER 616 HL.**

Macaulay, a young song writer, entered a five-year contract with A Schroeder Music Publishing promising them exclusive use of and copyright to anything he produced. The contract was extendible for a further five years. Whilst it could be terminated by the publishers with one month's notice, it could not be terminated by Macaulay. Apart from an initial £50 advance, Macaulay would receive no payment unless his work was published. A Schroeder had no obligation to publish any of Macaulay's work. 5

Macaulay argued that the agreement was contrary to public policy through being an unreasonable restraint of trade. A Schroeder argued that the doctrine of restraint of trade did not apply to their standard form agreement as contracts which were considered normal within the industry did not require justification under a public policy test of reasonableness. Macaulay won his case in the first instance court and Court of Appeal. A Schroeder appealed, unsuccessfully, to the House of Lords. 10

Lord Reid:

[T]he public interest requires in the interests both of the public and of the individual that everyone should be free so far as practicable to earn a livelihood and to give to the public the fruits of his particular abilities. The main question to be considered is whether and how far the operation of the terms of this agreement is likely to conflict with this objective. The respondent is bound to assign to the appellants during a long period the fruits of his musical talent. But what are the appellants bound to do with those fruits? Under the contract, nothing. ... if no satisfactory positive undertaking by the publisher can be devised, it appears to me to be an unreasonable restraint to tie the composer for this period of years so that his work will be sterilised and he can earn nothing from his abilities as a composer if the publisher chooses not to publish. 15 20

It was strenuously argued that the agreement is in standard form, that it has stood the test of time, and that there is no indication that it ever causes injustice. Reference was made to passages in the speeches of Lord Pearce and Lord Wilberforce in *Esso Petroleum Co Ltd v Harper's Garage* [1968] AC 269 HL with which I wholly agree. Lord Pearce said: 25

'It is important that the court, in weighing the question of reasonableness, should give full weight to commercial practices and to the generality of contracts made freely by parties bargaining on equal terms.' 30

But [the passage] refer to contracts 'made freely by parties bargaining on equal terms' ... I do not find from any evidence in this case ... [that this contract has been 'made freely by parties bargaining on equal terms'].

Lord Diplock:

[I]n refusing to enforce provisions of a contract whereby one party agrees for the benefit of the other party to exploit or to refrain from exploiting his own earning-power, the public policy which the court is implementing is not some 19th century economic theory about the benefit to the general public of freedom of trade, but the protection of those whose bargaining power is weak against being forced by those whose bargaining power is stronger to enter into bargains that are unconscionable. 35 40

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