Determination Number: AA 181/05
File Number: AEA 599/04

Under the Employment Relations Act 2000

BEFORE THE EMPLOYMENT RELATIONS AUTHORITY
AUCKLAND OFFICE

BETWEEN	Master Drive Services Limited (Applicant)
AND	Mark Heenan (Respondent)
REPRESENTATIVES	Stephen Franklin, Counsel for Applicant Stephen Clews, Counsel for Respondent
MEMBER OF AUTHORITY	R A Monaghan
INVESTIGATION MEETING	12 April 2005
SUBMISSIONS RECEIVED	26 April and 10 May 2005
DATE OF DETERMINATION	16 May 2005

DETERMINATION OF THE AUTHORITY

Employment relationship problem

[1] Master Drive Services Limited ("MDSL") says its former employee, Mark Heenan, breached his duty of fidelity towards it during his employment, and a restraint of trade provision still in force after his employment ended. It seeks damages, but by agreement this determination addresses liability only.

[2] Mr Heenan denies breaching the duty of fidelity, and says the restraint of trade was not binding on him. In the alternative he says the restraint is not enforceable on the ground that it is not reasonable, or that, as worded, it does not apply to his activities.

Duty of fidelity

[3] MDSL is in the business of providing training for drivers of forklifts, plant machinery, trucks, buses, fleet cars, and 'anything with wheels' for which a licence, certificate, endorsement or other qualification is required. It is a driver education provider.

[4] Mr Heenan was a primary school teacher, then a road traffic instructor with the Ministry of Transport, before becoming a shareholder/employee in the original Master Drive Services company. I turn later to the circumstances in which the original company became MDSL. In general Mr Heenan provided forklift and basic heavy vehicle licensing training and was based in Whakatane. MDSL employs people it calls 'specialists' who provide higher level instruction around New Zealand. There was no suggestion Mr Heenan provided instruction at that level.

[5] After he left his employment with MDSL Mr Heenan commenced a business of his own, offering training in the same activities as he had offered through MDSL. His business operated as

Industry Driver Training Limited ("IDT"). IDT was registered as a company on 15 January 2004 – the day before Mr Heenan's employment with MDSL ended. Mr Heenan and his wife are the directors of IDT, as well as holding shares in their own right and as trustees.

[6] The allegations of breach of duty of fidelity rely on: the date of IDT's incorporation; an assumption that a significant amount of work must have been necessary to prepare the company for business and the work must have been done while Mr Heenan was in MDSL's employ; the fact that clients were aware of Mr Heenan's pending departure from MDSL; and assertions that MDSL's local client base was effectively lost when Mr Heenan left.

1. Date of incorporation

[7] On its own, the date of IDT's incorporation is not determinative. A decision of the Employment Court in **Walden v Barrance** [1996] 2 ERNZ 598 illustrates why, and says this about the law applicable to whether Mr Heenan breached any obligation to his employer while still in employment:

> "… the respondent's employment contract was subject to an implied term that he was under a duty of fidelity to his employer to abstain from conduct likely to do damage to the employer's business or having the potential to undermine the relationship of trust and confidence. Obviously, an employee who has given notice must be entitled to make preparations for departure and for his or her future working life. There is nothing wrong with any of that. For example, the respondent was perfectly at liberty in his spare time to look for premises and order stationery, as he says he did. However, conduct will be of a different colour if the preparations are at the expense of injury to the goodwill of the employer's business or involve some serious dereliction of the continuing duty of trust and confidence." (p 616 ll 14 – 24)

[8] Examples of serious dereliction of the duty of trust and confidence while still in employment include soliciting clients for the new business, diverting for the benefit of the new business opportunities or information that should be made available to the employer, or otherwise misusing the employer's confidential information. However, as the above statement about the law makes plain, an employee is entitled to make some preparations for a working future, including preparing to establish a new business. That includes taking steps to register a new company while still in employment, provided the steps are essentially administrative and do not extend to attempting to obtain business for the new company at the employer's expense. There was no evidence that the steps were other than essentially administrative.

2. Preparing IDT for business

[9] Here there was no direct evidence that Mr Heenan did anything prior to the end of his employment other than seek advice on how to set up a business, and take further associated administrative steps such as arranging a bank account. He may also have sourced alternative training material, and I note there was no allegation that he appropriated MDSL's training material.

[10] Further, there was nothing in the evidence to support an inference that, during this period, Mr Heenan engaged in damaging conduct of a kind that amounts to a breach of the duty of fidelity.

3. Loss of clients, and client awareness of Mr Heenan's departure

[11] It was common ground that, since it commenced operating, IDT has conducted business with several clients of MDSL's. Even so Mr Heenan said he received from among those clients one or maybe two bookings for courses in February 2004, and did some other licence-related work for members of the public. He placed an advertisement in the local newspaper in February or March, and IDT was listed in the Yellow Pages which came out later in 2004. Other methods of obtaining

business included discussing his services when the opportunity arose, and relying on word of mouth.

[12] No doubt word of mouth was very effective in a small community. However there was no direct evidence that Mr Heenan made any improper approach to MDSL's clients prior to his departure from MDSL. I have been asked to infer that he did because of the fact business was conducted with these clients, and because of George Jarmulski's (MDSL's managing director's) evidence that clients were aware of Mr Heenan's departure before it occurred.

[13] The difficulty with Mr Jarmulski's evidence is that - prior to Mr Heenan's departure and at MDSL's request or at least with its knowledge - Mr Heenan arranged client visits to introduce two people who would be taking over his work. Inevitably through that process, clients became aware that he was leaving. Prior to one such visit the client concerned indicated to Mr Jarmulski that it was already aware Mr Heenan was leaving, but it was unclear from the evidence whether Mr Heenan had already arranged the relevant visit or whether Mr Jarmulski was making those arrangements himself. In any event the evidence did not support an inference that Mr Heenan had done any more than advise clients of his departure, and hence it did not support a breach of duty on Mr Heenan's part.

[14] Finally, the mere fact that MDSL may have lost its local client base does not support an inference that breaches of duty by Mr Heenan brought that about. Aside from the lack of evidence indicating that was so, there could be other reasons why those clients were lost. For example one major client subsequently put training work out to tender, and neither MDSL nor IDT was successful in obtaining the relevant work. It may also be that clients have simply followed Mr Heenan, whether because they chose to on becoming aware of his move by word of mouth or by seeing his advertising, or subsequently became dissatisfied with the service MDSL provided and then chose to look elsewhere, or because some other factor was operative. As I have said, there was no evidence that 'other factor' was a breach of the duty of fidelity on Mr Heenan's part.

[15] In conclusion, I find on the facts that there was no breach of the duty of fidelity.

Restraint of trade

1. Whether the restraint was binding on Mr Heenan

(a) Ratification of agreement made on behalf of company to be formed

[16] Mr Heenan acknowledged signing an employment agreement which contained a restraint of trade provision. However he said the agreement is not binding on the parties because it was a 'pre-incorporation' contract and was not ratified after incorporation. This position is based on s 182 of the Companies Act 1993, which reads in part:

> "(5) Notwithstanding the Contracts (Privity) Act 1982, if a pre-incorporation contract has not been ratified by a company, or validated by the Court … the company may not enforce it or take the benefit of it.

[17] A company also named Master Drive Services Limited was registered in 1992 ("the original Master Drive Services"). In 1999 Shell Services International (New Zealand) Limited ("SSI") bought that company's business, assets and name, with the settlement date being 1 July 1999. In turn SSI was the shareholder in Master Drive Services (SSI) Limited ("MDSSSI"), which was registered on 26 May 1999 for the purpose of carrying out the Master Drive Services business when the purchase was completed. MDSSSI was later renamed MDSL.

[18] In early May 1999 Mr Heenan was given a written employment agreement whose covering page read "Master Drive Services Individual Employment Contract for Employees joining the new Shell Services-owned Company." I will refer to it as the May 1999 employment agreement. The agreement cited the parties as Mr Heenan and "Shell Services International (New Zealand) Limited or its nominee". It also contained the restraint of trade provision with which this employment relationship problem is concerned. It was signed on behalf of 'the company' on 6 May 1999 and Mr Heenan signed it on 18 May 1999 – a week before MDSSSI was incorporated. The agreement was to take effect on 1 July 1999.

[19] The parties entered into an alternative arrangement before the agreement took effect. The arrangement does not affect the question of ratification and I will return to it shortly.

[20] Since there was no evidence indicating otherwise, I accept the board of MDSSSI did not formally ratify the May 1999 employment agreement. Neither of the parties provided detailed argument based directly or expressly on the relevant provisions of the Companies Act so on the face of the matter, by virtue of s 182(5) of the Companies Act, the agreement is not binding on the parties.

(b) Presence of implied or other agreement to the restraint

[21] If that finding is correct, it does not mean there was no binding employment agreement between the parties at all. Obviously there was, and the parties worked in accordance with it for well over three years. The question is whether it included a restraint of trade.

[22] Returning to the alternative arrangement, that arrangement was entered into soon after the May 1999 employment agreement was signed. Under it, Mr Heenan and his colleagues remained employees of the original Master Drive Services company (which was renamed during the term of the arrangement) and provided management services to MDSSSI through the original company.

[23] No separate written employment agreement was entered into in respect of the arrangement, rather the arrangement was discussed in shareholders' and employees' meetings and confirmed in correspondence. In particular, after discussing aspects of the negotiations to date, Mr Jarmulski said in a letter to Mr Heenan dated 6 May 1999:

> "Would you please sign, date and return to me the duplicate copy of this letter confirming your agreement to the following:
>
> 1…
> 4. that in the event that the decision is taken to retain shareholder employees as employees of MDS and contract their services to the new SSI Company your employment with MDS will be on the same terms and conditions as it would have been with the new SSI Company and, when it is decided to undo this arrangement, your employment will transfer to the new SSI company …"

[24] At the time Mr Jarmulski was writing as the general manager of the original Master Drive Services company. Mr Heenan was an employee of that company at the same time, so there is no issue of ratification and the question is simply one of identifying the content of the parties' agreement. The proposal contained in the letter is, in effect, that during the term of the arrangement (assuming of course that it proceeded), the parties' terms and conditions of employment would be those set out in the May 1999 employment agreement. When the arrangement ended, Mr Heenan would become an employee of MDSL.

[25] Mr Heenan signed the letter and dated it 18 May 1999, indicating his agreement.

[26] Although the May 1999 employment agreement was not ratified and hence could not be enforced by MDSSSI or MDSL, the agreement evidenced by the letter of 6 May is a different agreement between different parties. At the time it was open to the parties to consider the contents of the May 1999 employment agreement and decide whether or not those contents would become part of their own agreement. That is what they did. The subsequent failure by MDSSSI to ratify the May 1999 employment agreement does not affect the agreement between Mr Heenan and the original Master Drive Services company, as evidenced in part by the 6 May letter.

[27] As envisaged by the letter, the shareholder employees remained employees of the original company for a period. Confirmation of the decision to that effect was notified in a memorandum to Mr Heenan dated 17 July 1999. The terms and conditions of employment under that arrangement were, by adoption, those set out in the May 1999 employment agreement.

[28] The arrangement was 'undone' a little over a year later. By memorandum dated 12 July 2000 Mr Heenan and his colleagues were advised: "As from the 1 August 2000 you will become employees of Master Drive Services Limited [formerly MDSSSI]." The memorandum went on to ask the employees to complete an enclosed tax form in order to implement the change. Mr Heenan completed the form. That act, against the background of the intentions discussed in mid-1999 coupled with the continuation of employment with MDSL for another three years, mean I accept Mr Heenan agreed to the 'transfer' of his employment to MDSL. There was no suggestion to the contrary.

[29] The next question is whether the existing terms and conditions of employment were also 'transferred' to Mr Heenan's employment with MDSL. The memorandum of 12 July 2000 is not of itself sufficient evidence of agreement to such a transfer, but the extensive discussions of a year earlier identified an intention to that effect. Although Mr Heenan did not recall much about them I accept they occurred, and were confirmed in Mr Jarmulski's follow up memoranda. The memorandum of 17 July 1999 discussed the purpose of the management agreement in some detail, and said in an appendix:

> "On expiry of this arrangement current employee shareholders will formally become employees of the new company on the same terms and conditions - …"

[30] Finally, from August 2000 onwards Mr Heenan exercised rights present in the May 1999 employment agreement but not in any earlier agreement, and gave the notice of termination required under that agreement.

[31] A combination of all of these factors leads me to conclude that the terms and conditions set out on the May 1999 employment agreement became part of Mr Heenan's employment agreement first with the original Master Drive Services company, then with MDSL. Those terms and conditions included the restraint of trade.

2. The reasonableness of the restraint

[32] The relevant part of the restraint read:

> "5.4 You will not approach or solicit or undertake work for SSI or its nominee's customers or ex-customers in competition with the Company for a period of one year after you cease working for the Company."

[33] The proprietary interest MDSL sought to protect was its relationship with the major organisations that were its clients. While Mr Heenan probably developed a personal following in respect of his training courses, it was built up in the course of his employment with the various incorporations of Master Drive Services. I also take some note of the fact that Mr Heenan had been an employee/shareholder, and when SSI bought Master Drive Services it was effectively purchasing

an interest in those client relationships. MDSL was entitled to seek to preserve what it could of the relationships once Mr Heenan had left, hence I find it had a proprietary interest capable of protection.

(a) Geographical limit on the restraint

[34] As for the extent to which the company could protect its interests, an immediate difficulty with the restraint is the reasonableness of the lack of any geographical limit. After taking time to consider the point MDSL indicated at the investigation meeting that its concern was with an area bounded by Whakatane, Opotiki, Kawerau and Edgecumbe. I accept that is reasonable and amend the restraint accordingly.

(b) Period during which restraint enforceable

[35] The next question is whether a restraint period of one year is reasonable.

[36] The bulk of the work in the relevant geographical area came from a reasonably small group of readily identifiable organisations. They included Fletcher Challenge Forests/Tenon, Carter Holt Harvey, Norske Skog, Whakatane Board Mills, SCA Hygiene and Opotiki Trade Training. These companies' requirements for driver training were related to whether they were recruiting drivers, hence the requirements were difficult to predict, although seasonal changes had some effect on when training was required. Otherwise I was told clients tended to require training courses between one and four times a year, with Norske Skog requiring courses about once a month. To the extent it was possible to identify any degree of regularity in client requirements, on average courses were run approximately quarterly.

[37] None of this suggests a period as long as one year is reasonably necessary to protect MDSL's proprietary interests. Bearing in mind MDSL's reliance on the limited group of clients listed above, I further amend the clause so that the period of restraint is three months. I regard even that period as generous, and it should certainly be an adequate period to allow new MDSL staff to reaffirm the company's relationships with the clients concerned.

(c) The activities under restraint

[38] Regarding the activities under restraint, it seems that Mr Heenan was not to:

. approach customers or ex-customers of MDSL's, in competition with MDSL;
. solicit work from customers or ex-customers of MDSL, in competition with MDSL; or
. undertake work for customers or ex-customers of MDSL, in competition with MDSL.

[39] Some of the further difficulties with the restraint were removed by MDSL's acknowledgement that it was concerned only with Mr Heenan's activities in respect of the organisations listed in paragraph [36] above. Accordingly I formally amend the clause to apply only to approaching, soliciting work from or undertaking work for those clients where the relevant work is in competition with MDSL. I understood it to be common ground that the services IDT actually offered to those clients were in competition with MDSL. In the context of the present problem, there is no need to amend the clause any further.

3. Applicability of the restraint to Mr Heenan's activities

[40] Issue was taken with the use of the word 'you' in the restraint. MDSL says 'you' is a reference to Mr Heenan in whatever capacity he might be acting, while Mr Heenan says 'you' refers only to his personal capacity and not to activities carried out on behalf of IDT.

[41] Counsel for MDSL described as 'a nonsense' the argument that 'you' means Mr Heenan in his personal capacity and asserted that it is accepted that restraint of trade clauses need not be so specific as to cover every possible eventuality. He did not provide any authority for the assertion. Even if it is true that prolix clauses are not required, I believe the clause here is an example of the difficulties created by clauses sitting at the other end of the wordiness spectrum.

[42] I am not persuaded that 'you' extended to acts of Mr Heenan's which were carried out on behalf of IDT. The clause could, without becoming unduly prolix, have read "You will not, whether on your own account or on behalf of any other legal person, approach or solicit …" As it stands, the clause does not extend to the acts of the company in the manner contended by MDSL.

Conclusions

[43] There was no breach of the duty of fidelity there is no need to take that matter any further.

[44] There was a restraint of trade provision in the parties' terms and conditions of employment, amended to cover:

. the geographical area bounded by Whakatane, Opotiki, Kawerau and Edgecumbe;
. a period of three months after Mr Heenan ceased working for MDSL;
. the major clients of MDSL, being Fletcher Challenge Forests/Tenon, Carter Holt Harvey, Norske Skog, Whakatane Board Mills, SCA Hygiene and Opotiki Trade Training.

[45] The restraint applied to activities Mr Heenan carried out in his personal capacity, or as a sole trader. It did not apply to acts carried out on behalf of another legal entity.

[46] Accordingly, and subject to the following paragraph, within 7 days of the date of this determination, Mr Heenan is to file and serve a statement identifying what, if any, of the following activities he has carried out on his own account or as a sole trader in:

. approaching customers or ex-customers of MDSL's, in competition with MDSL;
. soliciting work from customers or ex-customers of MDSL, in competition with MDSL; or
. undertaking work for customers or ex-customers of MDSL, in competition with MDSL.

[47] The activities to be included in the statement may be limited to the geographical area, time period and clients set out in paragraph [44] above.

Costs

[48] Costs are reserved.

[49] The parties are invited to reach agreement on the matter. If they seek a determination of costs from the Authority they may file and serve memoranda setting out their positions.

R A Monaghan
Member, Employment Relations Authority