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Article Information

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Service: Corporate & Commercial, Employment & Labour, Mergers & Acquisitions

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NSW Court of Appeal rules on non-compete clauses in M&A transactions – What's new?

On 16 May 2023 the New South Wales Court of Appeal handed down its decision in *DXC Eclipse Pty Ltd Wildsmith* [2023] NSWCA 98. The case considered, among other things, the interplay between sale of business and employment agreement restraints. There are some significant points in the judgment for buyers of businesses to be wary of, not only when drafting and negotiating restraints, but also the type of employment contract to offer to a founder/seller of the business. We review the decision and what it means for non-competition clauses.

Background

In 2018 DXC Eclipse had purchased a company, Sable37 and sought to enforce a 7-year cascading restraint against a previous owner of that company, some four and a half years after the sale had occurred.

Mr Wildsmith, a former owner and Managing Director of Sable37, had stayed on and worked for DXC and Sable37's merged business for three years after the sale (pursuant to an obligation in the sale agreement to work for at least 12 months from completion).

Wildsmith's employment agreement also contained separate restraints and obligations, including a minimum employment period of 12 months and then a restraint in that employment agreement for a further 6 months. Wildsmith resigned in July 2021 and established a new software company, Will Thirty Three Pty Ltd, in December 2021.

DXC brought proceedings to enforce the restraint in the NSW Supreme Court in March 2022, on the basis that Mr Wildsmith's new business venture violated the business sale agreement restraints (the employment agreement restraints had by that time expired). Justice Parker found at first instance that Mr Wildsmith had not breached the restraint because there was little overlapping competition between the two businesses as they offered different services and dismissed DXC's application to block Mr Wildsmith from carrying on the business of Will Thirty Three. DXC appealed the decision.

The New South Wales Court of Appeal upheld the earlier decision by Justice Parker, dismissing DXC's appeal. Further, the Court held that the 7-year duration of the restraint was, in the circumstances, unreasonable.

Key points on non-compete clauses

The DXC decision has some important lessons for those involved in negotiating and drafting restraints:

- If the level of competition between a vendor and purchaser is slight or indirect, the greater the nature or extent of the restraint, the less likely it is to be reasonable (and enforceable).
- In analysing whether a vendor's new competing business poses a real commercial threat to the buyer's business the court's focus is on the core commercial activities and not the peripheral ones.
- A slight or insubstantial competition between businesses will generally not be enough to establish a breach of a non-compete clause.
- Even if significant consideration is paid for the acquisition of a business this does not remove the need to consider if the restraint was reasonably necessary to protect that business interest.
- The force of a contractual acknowledgement of the reasonableness of the restraints is unlikely to be given much weight if what is being acknowledged lacks clarity due to a cascading series of restraint periods.

So what's new?

While the Court accepted that a restraint in a business sale agreement protects different interests to a restraint contained in an employment agreement (and is limited to the period reasonably necessary to do so), it determined that the employment terms may indicate what the parties thought that reasonable period would be. A restraint-enforcement case will inevitably involve a Court asking whether the particular restraint is necessary to protect a legitimate business interest (and will refuse to enforce a restraint that is excessive). Therefore unmanaged content lurking in employment arrangements that suggest the period might be excessive, will involve risk for sale agreement restraints.

What was interesting in this judgment was the Court's willingness to identify the level of restraint that the parties had agreed was necessary to protect business goodwill by reference to the minimum employment period agreed on. The Court made a connection between the requirement for a seller to keep working in the business and the duration of the sale agreement restraint.

- Chief Justice Bell noted that:

  "I do not think that the disconformity between the restraint in Mr Wildsmith's Employment Contract and the maximum seven year restraint period in the SPA is wholly irrelevant."

- The duration of a requirement for the seller to remain employed in the acquired business is likely to provide a court with some indication of how long the buyer anticipates it will take to realise the goodwill acquired by it.
- This may spell danger for long post- transaction restraints where founders are only required to work for the buyer for a short period.

Where to from here?

- Most buyers want a reasonable period of time with the seller on board to assist with transitional issues and ensure customers stay, and for many sellers they do not want to stay on for a long time and work for the buyer – for example if they have been successful and wish to retire.
- The Court of Appeal's decision has made this a trickier area to navigate, and any party involved in negotiating an acquisition will need to be careful in negotiating post-completion employment arrangements to ensure acceding to a seller's request for a short-term contract does not derogate from the sale agreement restraint.