

DRAFTING ENFORCEABLE NON-COMPETE COVENANTS

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Non-Compete covenants are now standard and essential clauses in many contracts. Employers, purchasers of a business and franchisors all look to these covenants as a means of protecting their interests when there is concern that the other party would be in an unfair position competitively based on knowledge, information or skills gained or agreed to pass through a contract. Despite the importance of these clauses to certain parties, courts are often reluctant to enforce them as they constitute a restraint on trade. While a restraint on trade is presumed invalid as being against public policy, courts have recognized the importance of allowing parties the freedom to contract, and as such a restraint on trade that is ancillary to a valid agreement can be valid.¹ In determining whether such a restraint is valid, courts balance the public policy against restraining trade with the freedom of parties to contract by only enforcing restraints that are “reasonable between the parties and with reference to the public interest.”² This paper will expand upon how courts have determined the reasonableness of a restraint provision as well as drafting conventions that will help prevent a court from finding a restrictive covenant to be unenforceable.

PURPOSE

As evidenced by the following examples, the purpose of non-compete agreements can vary depending on the relationship existing between the parties making the agreement. In the employment context, employers may be concerned that employees, upon leaving the employer, may steal trade secrets gained during employment and use them to lure clients away from their former employer. In addition to the threat of stealing trade secrets, in a franchise relationship, a franchisor may worry that upon termination of the relationship, the franchisee may open a

¹ *Vancouver Malt & Sake Brewing Co. Ltd. v. Vancouver Breweries Ltd.*, [1934] 2 D.L.R. 310 (P.C.) at p. 315.

² *Elsley v. J.G. Collins Ins. Agencies Ltd.* [1978] 2 S.C.R. 916 at p. 923. [*Elsley*]

competing business and because of the former franchise relationship, client's may associate the new business with the franchisor thereby allowing it to benefit from the reputation and goodwill established by the franchisor. In the case of a purchase of a business, the purchaser may realize that if the seller is able to compete, the seller's reputation will allow him to keep all the clients the buyer was hoping to gain through the purchase of the business. This would make it difficult for seller's to get reasonable compensation for their business as it would deter people from purchasing businesses out of fear that what they are purchasing could turn out to be worthless.

In *RBC Dominion Securities v. Merrill Lynch*, [2008] S.C.J. No. 56, the Supreme Court was clear that while the common law does prohibit an employee from competing with his or her employer during the course of the employment relationship, once the relationship is terminated, employees are free, at common law, to compete with their former employer. With this in mind, it is clear that for certain parties, such as those in the examples above, further action needs to be taken to ensure protection of their interests. Properly drafted non-competition clauses, or in some cases non-solicitation and non-disclosure clauses, can serve to protect these interests.

REASONABLENESS

In determining the enforceability of a restrictive covenant such as a non-compete clause, Canadian Courts have struck a balance between restraining trade and providing parties the freedom to contract, by only enforcing covenants that are reasonable. As stated by the Supreme Court of Canada, the "covenant in any event must not go further than is reasonably adequate to give the protection that is to be afforded; if it goes too far or is too wide, either as to time or place or scope, it will not be enforced; and if bad in any particular, it is bad altogether."³

In *Elsley*, the Supreme Court of Canada set out a three-stage inquiry for assessing the reasonableness of a non-compete covenant which can be summarized as follows:

³ *Maguire v. Northland Drug Co.*, [1935] S.C.R. 412 at para 9. [*Maguire*]

- i) Did the plaintiff have a proprietary interest entitled to protection?
- ii) Were the temporal or spatial features of the clause too broad?
- iii) Is the covenant unenforceable as being against competition generally and not limited to proscribing solicitation of clients?⁴

What a court considers reasonable, in assessing the above inquiries, varies depending on the type of relationship between the parties entering into the non-compete agreement; that is, whether the parties are entering an employment contract, a franchise agreement or an agreement to purchase a business. The reason for this lies mainly in the different bargaining power of the parties. Whereas the party selling a business is likely to be in equal bargaining position to the party purchasing the business, there is a considerable imbalance in favour of the employer in employment agreements and to a lesser extent in favour of the franchisor in franchise agreements.

While the Supreme Court stated that the test of reasonableness can be applied “only in the peculiar circumstances of the particular case,”⁵ the following subsections expand upon what courts consider reasonable with respect to each of these factors.

Proprietary Interest

A non-compete covenant must be formulated to protect a proprietary interest that a party has a legitimate interest in. Courts will not enforce non-competition clauses that simply attempt to prevent another party from competing in an industry; the party attempting to enforce a non-competition covenant must demonstrate a legitimate proprietary interest. Proprietary interests

⁴ *Elsley*, *supra* note 2 at p. 925. This test continues to be applied; see for example *1488245 Ontario Ltd. (c.o.b. Riska Medical/Surgical Supply) v. Riska*, [2010] O.J. No. 5640.

⁵ *Elsley*, *supra* note 2 at p. 923.

that courts have recognized and afforded protection to, include trade secrets, confidential information and trade connections.⁶

Temporal and Spatial Features

The temporal and spatial features of a non-compete clause that courts will enforce depend largely on the type of business to which the clause applies. A reasonable spatial area varies depending on the area in which a company does its business. For example, while a non-compete provision in the sale of a dry-cleaning business may only need to extend to a certain area of a city, since people are unlikely to travel long distances to stay with the same dry cleaner, a non-compete provision in the sale of an internet business may require a significantly broader scope given the expanded customer reach allowed by the internet.

Similarly, the temporal restrictions in a non-compete clause will vary according to the time necessary to allow a party to attempt to rebuild customer relationships and compensate for any destabilizing effect the change or departure may have had.⁷ Another factor considered is the type of relationship that exists between the parties. While non-competition clauses of five years have been enforced in the sale of a business,⁸ courts are much less likely to enforce lengthy non-competition clauses in the employment context.⁹ Another factor taken into account in the employment context, is the position held by the departing employee and “generally, the higher the level of trust and confidence reposed in the employee, with a corresponding vulnerability of

⁶ *Elsley*, *supra* note 2 at p. 924.

⁷ *Anderson, Smyth & Kelly Customs Brokers Ltd. v. World Wide Customs Brokers Ltd.* (1996) 184 A.R. 81 at paras. 32 & 34. [Anderson]

⁸ See for example, *Doener et al v. Bliss & Laughlin Industries Inc.* (1980), 117 D.L.R. (3d) 547 (SCC).

⁹ For example, in *Cameron v. Canadian Factors Corp. Ltd.* (1970), 18 D.L.R. (3d) 574 (SCC) at p. 586., the court held that anything beyond two years would have been beyond protection and that a one year period would likely have been sufficient.

the employer, the longer the period [the courts will be willing to enforce a non-compete provision] will be.”¹⁰

Against Competition Generally

Courts have held time and again that where a non-solicitation clause would suffice they are unwilling to enforce a non-compete agreement. This is seen in the language of the Ontario Court of Appeal in *Lyons v. Meltari*¹¹, at paras 48-49, where Justice MacPherson stated; “As a general rule, non-solicitation clauses are permissible; “in exceptional cases” only, non-competition clauses will be upheld.” The use of non-competition clauses was further restricted in the employment context as a result of *Friesen v. Mackague*¹², where the court held that a non-competition clause is only reasonable “where the nature of the employment will likely cause customers to perceive an individual employee as the personification of the company or the employer.” As such, a non-competition clause should be avoided if a non-solicitation and a non-disclosure clause would adequately protect the party’s interests.

JUDICIAL INTERPRETATION

With courts applying a restrictive approach in determining what is reasonable and noting that one unreasonable aspect of a clause will lead to the entire clause being struck out, parties have looked for the courts’ support in rectifying clauses that are unreasonable because of ambiguity or what appears to be a severable term. Unfortunately, as is demonstrated below, courts in Canada provide little assistance in these scenarios.

Ambiguity

In a recent Supreme Court decision, the court made it clear that a non-competition clause, especially one drafted in an employment context, will be interpreted narrowly and if found

¹⁰ *Anderson, supra* note 7 at para. 32.

¹¹ [2002] O.J. No. 3462 (Ont. C.A.).

¹² (1992), 96 D.L.R. (4th) 341 (Man. C.A.). [*Friesen*]

ambiguous will be struck out in its entirety. In *Shafron v. KRG Insurance Brokers (Western) Inc.*,¹³ the Supreme Court of Canada held that the geographic area defined in the clause as “Metropolitan City of Vancouver” was ambiguous and thereby unenforceable because there is no such defined area¹⁴.

Severability

When a portion of a non-competition clause is found to be unreasonable or ambiguous, courts have been asked to sever that portion of the clause. Unfortunately for those hoping to enforce the clause, Canadian courts have given severability or the “blue-pencil test” very limited application in terms of rectifying an unenforceable non-compete clause. As stated by the Supreme Court of Canada, “[u]nder the blue-pencil test, severance is only possible if the judge can strike out by drawing a line through, the portion of the contract they want to remove, leaving the portions that are not tainted by illegality, without affecting the meaning of the part remaining.”¹⁵ Judges, as a result, are hesitant to use the blue-pencil approach as it is suggested that “[c]ourts inescapably make a new bargain for the parties when they use the blue pencil approach.”¹⁶

This view was further supported in *Shafron*, where the Supreme Court overturned the British Columbia Court of Appeal’s decision to use notional severance to change the temporal restriction on the non-compete from the ambiguous “Metropolitan City of Vancouver”, to specific parts of the Greater Vancouver region. The Supreme Court stated that since there is no bright line test available for reasonableness, notional severance in this instance simply amounted

¹³ (2009) SCC 6.

¹⁴ There are two defined areas of Vancouver, The Greater Vancouver Region and the City of Vancouver.

¹⁵ *Transport North American Express Inc. v. New Solutions Financial Corp.* [2004] 1 S.C.R. 249 at para 57.

¹⁶ *Transport*, *supra* note 15 at para 30.

to the court rewriting the contract.¹⁷ Additionally, the court refused to “blue pencil” the clause to read “City of Vancouver” because testimony at trial made it clear that the drafter meant the City of Vancouver and something more. Therefore, to interpret “Metropolitan City of Vancouver” as simply the “City of Vancouver” would impose a term the parties had not bargained for, and as stated by the British Columbia Court of Appeal, “the Purpose of the severance is to retain the bargain made by the parties, not to impose a new bargain on them.”¹⁸

DRAFTING CONVENTIONS

In drafting a non-competition clause, since courts have been very particular in what they determine to be reasonable, it is important to draft the terms as narrowly as possible to ensure that the clause remains enforceable. As was demonstrated above, if a court finds one aspect of the clause not to be reasonable it will strike it out in its entirety. This was embodied in the Supreme Court statement “if bad in any particular, it is bad altogether”¹⁹. In addition, it is imperative that the clauses be drafted precisely to reflect exactly what the parties intend because the Supreme Court has made it clear that it will not rectify ambiguities or sever terms unless doing so will not alter the bargain between the parties.

One of the most important considerations in drafting a non-competition clause is determining whether such a clause is in fact necessary. Courts have often struck down a non-compete as not being reasonable because a non-solicitation or non-disclosure clause would have provided adequate protection. While in the purchase of a business a non-competition clause may be applicable in more situations, in the employment context a non-competition clause is rarely

¹⁷ The decision went on to state that the reason rewriting restrictive covenants is to be avoided is because it would allow employers to draft overly broad restrictions with the comfort that if they are found to be unreasonable or ambiguous the court would simply rewrite them, thus placing an onerous burden on the employee. See *Shafron*, *supra* note 13 at paras 39-41.

¹⁸ *Canadian American Financial Corp. (Canada) Ltd. v. King and Douglas W. King Marketing Corp.* (1989), 36 B.C.L.R. (2d) 257 (C.A.) at p. 271.

¹⁹ *Maguire*, *supra* note 3 at para 9.

necessary or enforceable.²⁰ Even when a non-competition clause is thought to be necessary, justified and reasonable it is prudent to include non-disclosure and non-solicitation clauses to provide protection to some of the party's interests in the event that the non-compete is ruled unenforceable.²¹

Conclusion

There are many situations in which a non-compete clause provides important protection to a party's economic interests. At the same time courts have made it clear that it will only enforce these clauses if they are reasonable in their entirety and that a court will not sever offending terms or interpret ambiguous terms. With this in mind, it is crucial that a party i) consider what legitimate interests it has that need protection and whether these interests can be protected via a non-solicit or non-disclosure clause; ii) draft the clause narrowly to protect against only those actions, in the timeframe and area, that threaten those interests and iii) draft the clause precisely to ensure there are no ambiguities.

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²⁰ *Freisen, supra* note 12.

²¹ It is not clear that a court would not simply strike out these additional protections for the same reason the courts will not rewrite a restrictive covenant as discussed in footnote 17, namely that it would allow employers to draft overly broad non-compete clauses placing an onerous burden on the employee. Nonetheless, it is suggested that drafting non-solicitation and non-disclosure clauses in addition to a non-compete clause is worth the effort in the event that they do provide some additional protection. See for example: Stuart Rudner, "Non-competition Clauses: Not Worth the Paper They're Written on?" *Labour & Employment Communique* (23 June 2003).