Non-Competition Covenants

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This paper contains an overview of the legal principles governing restrictive covenants and non-solicitation covenants and a discussion of some of the practical considerations which pertain to their enforcement.

Restrictive covenants are most often found in written employment contracts and in agreements for the sale of businesses. With the growing popularity of employment contracts, there is a greater use of restrictive covenants but I would suggest that it is nevertheless the case that their importance has been diminished or superseded by the expansion of the concept of the fiduciary obligations following the decision of the Supreme Court of Canada in *Canadian Aero Services Ltd.* v. *O'Malley*.[1]

There has been, at least in Ontario, a discernible tendency to uphold employment contracts and to give a broad application to limitation provisions and disclaimers in such contracts.[2] This judicial deference, however, is not extended to restrictive covenants and an employer wishing to enforce such a covenant has a significant evidentiary burden at trial, or, more commonly, in the context of an application for an interlocutory injunction.

I. GENERAL PRINCIPLES

The general principles governing contracts in restraint of trade have been well understood since Lord Macnagthen's statement in *Nordenfeld* v. *Maxim Nordenfelt Guns and Ammunition Co.*:

> *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 of 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, that is in reference to the interests of the parties concerned and reasonable in reference to the interests of the public, so 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.[3]

The Nordenfelt principle was adopted by the Supreme Court of Canada in *Elsley* v. *J.G. Collins Insurance Agencies Ltd.*[4] In that case, the general manager of the plaintiff, a general insurance business, left to set up a competing business in the face of a written covenant not to compete as a general insurance agent for five years after leaving the plaintiff's employment, in the city of the employment or in certain other areas in the same county. The Court held that the covenant was enforceable in the particular circumstances of that case due to the fact that, on the evidence, there was a close personal acquaintance between the defendant and the clients or customers of the plaintiff's business.

The burden of proof was stated to be on the plaintiff employer who sought to rely on the clause. The plaintiff was required to demonstrate that in the circumstances, a non-solicitation covenant, that is, a covenant not to solicit the former employer's customers, would not have been adequate to protect the company's customer base. The evidence disclosed that there has been no solicitation by the defendant of the plaintiff's customers yet a large number of the customers followed the defendant to his new firm, thus demonstrating that a simple non-solicitation covenant would not have sufficed to protect the employer's interests. Dickson, J., speaking for a unanimous Court, stated the applicable principles to be as follows:

A covenant in restraint of trade is enforceable only if it is reasonable between the parties and with reference to the public interest. As in many of the cases which come before the Courts, competing demands must be weighed. There is an important public interest in encouraging restraints on trade, and maintaining free and open competition unencumbered by the fetters of restrictive covenants. On the other hand, the Courts have been disinclined to restrict the right to contract, particularly when that right has been exercised by knowledgeable persons of equal bargaining power. In assessing the opposing interests, the word one finds repeated throughout the cases is the word "reasonable". The test of reasonableness can be applied, however, only in the peculiar circumstances of the particular case. Circumstances are of infinite variety. Other cases may help in enunciating broad general principles but are otherwise of little assistance.[5]

The mandate of the Courts is therefore to balance the public interest in open competition with the parties' freedom to contract. A covenant in restraint of trade is *prima facie* unenforceable and the party who seeks to rely on such a covenant has the burden of proof of establishing its reasonableness. As Dickson, J. points out, what is reasonable between the parties depends on the particular circumstances of each case.

However, it can be said that in any case, the party relying on the covenant must first show that it has a legally recognized interest in respect of which it is entitled to seek protection. In particular, the Courts have recognized and afforded protection to an employer's interest in protecting its trade secrets and confidential information and its goodwill, particularly with respect to its client connections. It is therefore most unlikely that a Court would enforce a covenant applicable to a junior level employee who had no apparent ability to significantly adversely affect his employer's goodwill, that is, no close acquaintanceship with customers nor knowledge of particular confidential information. The indiscriminate use of standard form restrictive covenants in employment contracts, without reference to the particular position of the employee in question, will render the covenant unenforceable. There must be a clearly demonstrated need to restrict certain of the employee's rights to engage in free competition with the former employer.

Assuming an interest worthy of legal protection, the employer must then show that the covenant goes no further than is actually required to protect the interest in question. If an employer has overreached in seeking to protect his trade connection, the restrictive covenant will not be enforced. There is no power in the Courts to read down or otherwise alter the covenant as it appears in the agreement. The nature of the restrictive covenant must be examined and it must be fairly referable to the interest sought to be protected. For example, a clause which seeks to prevent competition in a business activity other than that directly carried on by the employer will not be upheld.

The covenant must be seen to be reasonable both in terms of duration and geographical application. This will require the employer to show, by affirmative evidence, that the nature of its business is such that there is a real potential of harm to its legitimate interests from the former employee's competition in the entire area specified in the covenant and for the stated duration of the covenant. This will often invite a searching enquiry into the manner in which the employer carries on business including the specific nature of its services or products, its approach to marketing, the profile of its clientele, its bidding practices, and other issues, many of which litigants would prefer not to make the subject of cross-examination or argument in Court. In summary, at this stage of the enquiry, the question to be asked is what are the interests of the employer that need to be protected, against what is the employer entitled to have them protected, and over what duration and geographical area.

There are a number of other points which appear to be well settled. An ambiguity in the text of the covenant will normally be interpreted contra proferentem to the employer. Therefore, a prohibition against solicitation of "accounts" within the employee's assigned sales territory will be interpreted to apply only to the employer's existing customers at the time of termination, see *W.R. Grace and Co. of Canada Ltd.* v. *Sari.*[6]

A covenant which merely prevents solicitation of the employer's customers but otherwise allows unrestricted competition, that is, a so called "non-solicitation covenant" is not a covenant in restraint of trade and therefore, unlike restrictive covenants is not *prima facie* void and normally will be enforceable.

As the Court's willingness to restrict one's freedom to compete depends substantially on the legitimacy of the interest which such a covenant is designed to protect, such restrictions have been upheld more frequently in the context of the sale of a business than in the employment context. A purchaser of a business has an obvious legitimate need to protect the asset he has paid for against the threat of competition from the vendor.

II. THE RELATIONSHIP BETWEEN NON-COMPETITION COVENANTS AND FIDUCIARY OBLIGATIONS

One obvious approach would be to say that if the parties had defined their rights and obligations with respect to the solicitation of the employer's customers in a written contract, that should govern the matter. The prevailing judicial attitude, however, appears to be that irrespective of the presence or absence of a written restrictive covenant, fiduciary obligations will be imposed on the parties for the purpose, in the most general terms, of enforcing ethical business practices. In some instances, the Courts will go so far as to enforce a fiduciary obligation which if embodied in a restrictive covenant would be unenforceable as not meeting the criteria of reasonableness. In *Cregoe, Mealing & Clarke Ltd.* v. *Barker*,[7] Krever, J. (as he then was) held that a restrictive covenant was too broad and therefore unenforceable. However, His Lordship granted an interlocutory injunction to enforce a similar fiduciary obligation against the defendant (a former senior employee of the plaintiff) from soliciting the business of the plaintiff's existing customers. The Court stated:

> *The paragraph is, in my opinion, not simply a non-solicitation covenant; it is manifestly a non-competition covenant and, as such, a covenant in restraint of trade which will only be enforced if it can be shown to be reasonable and not contrary to the public interest. The covenant is unenforceable on the following grounds:*
>
> *1. It contains no geographical or spacial limitation and, therefore, is wider than is reasonably necessary to encompass the defendant Barker's sphere of interest;*
>
> *2. It purports to apply to all of the plaintiff's clients, not merely those who dealt with the defendant Barker; and*
>
> *3. Its temporal limitation or term is unreasonably long, that is, longer than is reasonable for the protection of the plaintiff's interests.*
>
> *The unenforceability of the covenant, however, is not a complete answer to the Plaintiff's motion. In light of the reasoning of Estey, C.J.H.C. in* Alberta Ltd. et al v. Mountjoy et al. *(admittedly in action for damages and not an injunction), there is, I am satisfied, a strong prima facie case that the plaintiff is entitled to have enjoined the defendant Barker's breach*

of obligation arising out of his fiduciary duty to the plaintiff, arising out of his former position as a senior employee and officer, not to solicit the business of the plaintiff's clients.

Prior to the leading decision of *Albert Ltd.* v. *Mountjoy,*[8] an employer would normally require a properly worded restrictive covenant to prevent a senior employee from leaving and soliciting his customers, the Supreme Court's decision in *Elsley*[9] being an excellent example of such a situation. There was no discussion of fiduciary obligations in the *Elsley* case. In *Albert and Mountjoy* the same result was accomplished through a fiduciary obligation analysis. The case concerned an employee who was manager of the plaintiff's general insurance business. Unhappy with a change of ownership, Mountjoy resigned from his position and, together with a junior employee of the agency, established a competing business. Without apparently directly soliciting the plaintiff's customers, the defendants nevertheless ended up with a significant portion of the plaintiff's customers. Estey C.J.H.C. (as he then was), after finding that Mountjoy was a fiduciary, commented:

It is now beyond argument that a departing servant has the right to compete with his former employer. He may do so by establishing a business in direct or partial competition and he may bring to that business the knowledge and skill which he acquired while in the former service, including knowledge and skill directly obtained from the previous master in teaching him his business.[10]

However, he imposed an important limitation on this with respect to the use of this knowledge to solicit clients of the former employer:

[T]he ex-employee is not entitled to make "an unfair use" of information acquired in the course of his employment, nor may he use confidential information so acquired to advance his own business at the expense of that of his former employer.[11]

It can be seen that the advantage which this approach has over the contractual restrictive covenant is that fiduciary obligations are flexible principles which can be tailored to ensure

particular standards of business ethics in the particular circumstances, whereas a restrictive covenant sets out to prohibit all competition thereby leaving the proponent of such a covenant to attempt to justify it with respect to the extremely vague concept of reasonableness in a general context.

In *Wallace Welding Supplies* v. *Wallace*[12] the defendant had signed a restrictive covenant stipulating that he would refrain from the sale of the plaintiff's products for a six month period. The defendant immediately commenced business and began soliciting the customers of the plaintiff company but advised them that he could not offer those products which were sold by the plaintiff until expiry of the six month period. The Court found that the defendant had breached the covenant even though it had not sold the products in question during its term. In addition, the defendant was found to be in breach of its fiduciary duty by virtue of his engaging in a business in competition with the plaintiff company. The Court rejected the defendant's argument that his obligations were confined to the restrictive covenant:

> *[T]he duty (not to act unfairly) may co-exist with the non-competition covenant. The latter is an agreed restraint on the right of a former employee to compete. The former is a common law duty that is owed to a competitor that is a former employer. They are independent of each other.*

The cases have recognized the inherent inequality of bargaining power between employers and employees in this context. A restrictive covenant may be ineffective in protecting the employee's interest if it is entered into after the employment relationship has begun. In *Mercury Marine Ltd.* v. *Dillon*,[13] the Court refused to enjoin a former employee from accepting employment with a competitor, contrary to the provisions of the restrictive covenant, on the basis that the agreement had been entered into after the company had agreed to employ the individual who was to be bound by the covenant. In determining that the covenant was probably unenforceable, the Court referred to the "unfair" manner of obtaining the covenant:

[I]n this case, there is a disparity in bargaining power [...] *I am persuaded that the Plaintiff took unfair advantage of Dillon in extracting the covenant from him at the time it had already been agreed to employ him. Not only will the Court scrutinize it more rigorously but may well refuse to enforce it as a result.*[14]

To the same effect is the statement of Dickson, J. in *Elsley*:

A different situation, at least in theory, obtains in the negotiation of a contract of employment where an imbalance of bargaining power may lead to oppression and a denial of the right of the employee to exploit, following termination of employment, in the public interest and in his own interest, knowledge and skills obtained during employment. Again, a distinction is made. Although blanket restraints on freedom to compete are generally held unenforceable, the Courts have recognized and afforded reasonable protection to trade secrets, confidential information and trade connections of the employer.[15]

III. THE PUBLIC INTEREST

Once the party seeking to rely on a restrictive covenant has satisfied the Court of its reasonableness *inter partes*, it is still open to the party challenging the covenant to demonstrate that it is contrary to the public interest and on that account, ought not to be enforced. There are a considerable number of reported decisions in which physicians have attempted, sometimes successfully, to bar the enforcement of restrictive covenants. The argument in each case is that by giving effect to the covenant, the community in question would be deprived of necessary medical services in the defendant's medical specialty or at least that the community would be denied a reasonable choice of practitioners. As a guide to discerning the substantive content of the applicable public policy, the Courts look to statutes in *pari materia*, to the views of the professional governing body concerned, and to the manner in which the professional business is carried on. An example of this approach is to be found in the reasoning of Mr. Justice Donohue in *Sherk* v. *Horwitz*:

It will, therefore, be apposite to consider how statute law in the Province of Ontario affects medical care for the residents of this Province. To a considerable extent, the evidence of Dr. Sherk shows how the implementation of the Health Services Insurance Act, which was passed

in 1967 [1968 - 69 Ont. c. 43] (now R.S.O. 1970 c. 200) has affected the medical practitioners. He stated that the problem of unpaid medical bills has virtually ceased to exist. The financial side of medical practice has been greatly improved.

Now the beneficial purpose of this legislation is to provide the widest medical care for the residents of the Province. Clearly this is in the public good. And I think it follows that the public are entitled to the widest choice in the selection of their medical practitioners.

In the light of this modern development, Exhibit 26 at the trial may have some special significance where in May 1971, a resolution of the Council of the Ontario Medical Association was passed as follows:

> *Resolved that the Ontario Medical Association disapproves the concept of restrictive covenants in the contracts of one physician with another.*

A further feature to be considered is whether a restrictive covenant between medical people tends to further limit the right of the public to deal with a profession which has a strong monopoly position. I believe that it does and I think that to widen that monopoly would be injurious to the public.[16]

The position of the medical profession is obviously somewhat unique. In a commercial context, particularly in a smaller community, it might be possible for a Court to be satisfied that enforcement of a covenant would unduly restrict the availability of certain services or products to the public and should therefore be unenforceable. It might be suggested that a covenant should not be enforced on public policy grounds if it would have the likely effect of promoting conduct which could be characterized as an offence or as a reviewable practice under the *Competition Act* or under provincial consumer protection legislation. Clearly any covenant imposing an obligation in contravention of human rights legislation would be unenforceable.

IV. WRONGFUL DISMISSAL AND ENFORCEMENT OF THE RESTRICTIVE COVENANT

While no Canadian case has specifically decided the point, it is submitted that an employer ought not to be able to enforce a restrictive covenant if the termination is wrongful, that is, in the sense that the termination purported to be for cause when cause is not proved or when the notice, or severance pay in lieu, is not sufficient in terms of what is required by the written employment contract, or by the common law as the case may be. In other words, an employer who repudiates or breaches an employment contract should not be entitled to rely on a restrictive covenant contained in it.

An interesting situation would arise where an employee is dismissed, other than for cause, in circumstances where there exists a written employment contract containing a restrictive covenant but with no specified notice requirement in the event of termination. If there is a specified notice and the same is complied with by the employer, then the restrictive covenant will obviously apply. See *Maxwell* v. *Gibson's Drugs Ltd.*[17] If the termination period was not specified, that is, if a reasonable notice requirement was implied, then the restrictive covenant ought not to be enforceable on the employer's behalf unless reasonable notice has in fact been given. Moreover, the existence of the restrictive covenant should be a significant factor in determining what period of time constitutes reasonable notice for the simple reason that a restriction on one's ability to compete is a major factor governing the ability to mitigate one's damages. Therefore, the existence of an enforceable restrictive covenant should increase the notice period.

An employer wishing to enforce a restrictive covenant in the circumstances of a termination in which the length of notice is in dispute will have a significant evidentiary burden. In the context of an interlocutory injunction, the employer would be required to satisfy the Court that there was a strong *prima facie* case, or at least a substantial issue to be tried with respect to each of the following issues:

a) that there was a valid written employment contract;

b) that the restrictive covenant therein was clear in its terms and which, if enforced, would bar the conduct in which the defendant is currently engaged;

c) that the restrictive covenant protected a legitimate business interest of the employer;

d) that the restrictive covenant was no broader in terms of time or geographical application than is required to protect the employer's legitimate interest;

e) that the employer itself had discharged its obligations under the contract, that is, to provide the notice required either under the contract or pursuant to the common law; and

f) if raised by the defendant, to counter any applicable public policy arguments.

CONCLUSION

While the principles governing restrictive covenants are well settled, the requirements of "reasonableness" and the dictates of public policy are sufficiently vague to ensure substantial litigation in many different factual contexts. The practitioner will wish to carefully and narrowly draft the restrictive covenant to deal directly with the specific interests which the employer seeks to protect. The expanding concepts of fiduciary obligations are quite adequate to deal with the broader risks of unethical business competition in general.

FOOTNOTES

1. *Canadian Aero Services Ltd.* v. *O'Malley* (1974), 40 D.L.R. (3d) 371 (S.C.C.).

2. For example, *Douglas Queen* vs. *Cognos Inc.* (1990), 69 D.L.R. 288, 74 O.R. (2d) 176.

3. *Nordenfeld* v. *Maxim Nordenfelt Guns and Ammunition Co.,* [1984] A.C. 535 at 565.

4. *Elsley* v. *J.G. Collins Insurance Agencies Ltd.* (1978), 83 D.L.R. (3d) 1.

5. *Ibid.* at 5.

6. *W.R. Grace and Co. of Canada Ltd.* v. *Sari* (1980), 28 O.R. (2d) 612.

7. *Cregoe, Mealing & Clarke Ltd.* v. *Barker* (1985), 4 C.P.E. (3d) 143, Krever J.

8. *Albert Ltd.* v. *Mountjoy* (1977), 36 C.P.R. (2d) 97, 16 O.R. (2d) 682, 79 D.L.R. (3d) 108.

9. *Supra* note 4.

10. *Supra* note 8, D.L.R. at 112.

11. *Ibid.* at 115.

12. *Wallace Welding Supplies* v. *Wallace* (1986), 11 C.C.E.L. 108 (Ont. H.C.J.).

13. *Mercury Marine Ltd.* v. *Dillon* (1987), 56 O.R. (2d) 266 (Ont. H.C.J.).

14. *Ibid.* at 270.

15. *Supra* note 4 at 6.

16. *Sherk* v. *Horwitz,* [1972] 2 O.R. 452 at 456.

17. *Maxwell* v. *Gibson's Drugs Ltd.* [1979] 3 A.C.W.S. 334 (B.C.S.C.).