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Restrictive covenants in employment contracts: Canadian approach

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Businesses and their major investors often seek to minimise the potential harm that can be inflicted by former employees after they leave employment. Including restrictive covenants into an employment agreement is one of the methods used to tackle this issue. However, contractual clauses that attempt to restrict the ability of a former employee to compete with the employer or to solicit its customers, suppliers or employees may be unenforceable.

In Canada, attempting to restrict the ability of a former key employee (in this article, any employee who has fiduciary duties) to compete with the employer or to solicit its customers, suppliers or employees can be tricky. The law concerning these kinds of restrictive covenants has been the subject of substantial judicial revision, refinement and inconsistency in the last several years.

Against this background, the article:

- Summarises the ways in which the common law protects businesses from unfair treatment by departing key employees.
- Provides an overview of the law relating to non-competition and non-solicitation agreements.
- Analyses the judicial trends concerning enforcement.
- Provides practical tips for drafting an enforceable restrictive covenant.
- Reviews the circumstances in which employers in Canada's largest province, Ontario, may use non-competition agreements without having to establish that the covenant is a "reasonable" restraint of trade.
- Looks at the unique civil law approach in the Province of Québec.

In doing so, the article will make several comparisons between the Canadian legal position and the US (non-state specific) approach.

COMMON LAW PROTECTION

Fiduciary duties of departing key employees

An executive is typically deemed to owe fiduciary duties to the employer because the employer places significant trust in the executive to exercise his discretion in the best interests of the employer, with the resulting vulnerability of the business to the abuse of that trust. Outside of the executive team, other employees may or may not owe fiduciary duties, depending on the particular facts.

The fiduciary duty requiring an employee to act honestly and in good faith with a view to advancing the employer's best interests usually survives the termination of the employment relationship.

Canadian courts apply the concept of fiduciary duty in a broad and flexible manner to respond to the facts of each particular case. The courts will usually find a breach of fiduciary duties where the key employee uses his position of trust and discretion to advance his own interests over the interests of the employer.

Breach of fiduciary duties exemplified

Examples of a breach of an employee's fiduciary duties following the termination of employment include:

- Disclosure of confidential information, including but not limited to trade secrets, marketing plans, customer lists, corporate strategies and employee lists, to a third party (including a new employer).
- Soliciting the employer's customers or other employees.
- Exploiting a corporate opportunity of the employer even when the employer does not pursue it.
- Resigning without providing adequate notice and then interfering with the employer's relationship with suppliers, customers and other third parties, except for the purpose of legitimate competition.
- Failing to disclose to the employer any secret profits earned from the employment relationship.
- Setting up a competing business while still an employee.

This is not an exhaustive list. Breaches of fiduciary duties may take other forms where the key employee acts in a manner that is detrimental to the interests of his employer.

RESTRICTIVE COVENANTS: OVERVIEW

Non-competition covenants

Canadian courts generally consider non-competition covenants in employment contracts to be "in restraint of trade" and therefore unenforceable. Canadian courts, like many US state courts, will not enforce agreements that prevent competition by a former key employee, unless an employer can establish that the covenant is reasonable, that is, it:

- Goes no further than is necessary to protect the employer's legitimate business interests because it is reasonable in:
 - duration;
 - geographic scope; and
 - all other aspects (such as scope of activity covered).
- Does not unduly restrain the key employee from making use of their skills and talent.
- Is not contrary to the public interest.



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In other words, the employer is not entitled to use a non-competition clause to protect its competitive position. It can only use such a clause to protect its proprietary interests that, under the circumstances, reasonably need protection. The extent of the protection to which an employer is entitled will vary depending on the nature of its business and the role of the key employee. In addition, the Ontario Court of Appeal has held that courts will not enforce non-competition clauses unless the employer can demonstrate that a non-solicitation clause is insufficient to protect the employer's proprietary interest (*H L Staebler Company Limited v Allan* (2008), 92 OR (3d) 107 (CA)).

Because of the courts' antipathy towards restrictive covenants in employment contracts, it is challenging to draft a non-competition clause that both is reasonable in the courts' view and at the same time offers adequate protection to the employer. Unlike in some US state courts, the courts in Canada will not amend an unenforceable clause to make it acceptable, but rather will strike all or part of the offending clause (see below, *Judicial trends: Traditional approach: strike down or blue pencil severance*). As a result, employers often compromise by drafting a non-competition clause in language that is not as restrictive as it would like to improve the likelihood of enforceability.

Non-competition clauses in agreements for the purchase and sale of a business are more likely to be enforceable because the courts consider that the two parties are more likely to enjoy relatively equal bargaining power, and because the clause may be necessary to ensure the buyer's newly acquired business is not subverted by the previous owners, some of whom may be managers and executives. As a general matter, non-competition clauses relating to a business sale start running with the close of the sale.

Non-solicitation covenants

Canadian case law suggests that, while courts are quite adverse to non-competition clauses, they are more inclined to enforce non-solicitation clauses. However, before the courts will enforce a non-solicitation covenant, the employer must show that the covenant is necessary in the context of the nature of the business carried on and the type of work carried out by the employee.

The key employee must be someone who has not merely acquired knowledge of the employer's customers but, in addition, has acquired influence over them through the key employee's business dealings with them. The level of reliance may vary, however, with the sophistication of the client.

In most cases involving non-executive sales representatives, a non-solicitation clause should be restricted to customers of the employer with whom the key employee dealt and should not include other customers of the employer (for example, customers with whom the key employee did not deal or of which he had no knowledge).

JUDICIAL TRENDS

Traditional approach: strike down or blue pencil severance

Not surprisingly, when employers ask a Canadian court to enforce a non-competition agreement, the courts frequently decide that the agreement is an unreasonable restraint of trade and refuse to issue an injunction against the competing key employee (see above, *Restrictive covenants: overview: Non-competition*

clauses). Traditionally, the common law imposes harsh sanctions on an employer who "over-reaches" (that is, imposes a term on an employee that is too harsh) and requires a key employee to sign an unreasonable restrictive covenant.

Traditionally, if a court decided that a restrictive covenant was unreasonable or uncertain, it had only two alternatives:

- Strike down the whole restrictive covenant.
- Sever the offending parts of the restriction, if the language permits, and save the rest (sometimes called "blue pencil severance").

The choice between the two alternatives is said to depend largely on the relationship between the parties. However, the courts are not likely to apply the doctrine of severability (and therefore are reluctant to blue pencil the agreement) if the non-competition agreement was made between the employer and the employee.

The Supreme Court of Canada (Supreme Court) has recently set out the following rules concerning the courts' blue pencil severance discretion (*Shafroon v KRG Insurance Brokers (Western) Inc*, 2009 SCC 6, [2009] 1 S C R 157P) (*Shafroon*):

- Blue pencil severance "may be resorted to sparingly".
- The part to be severed must:
 - be "trivial"; and
 - "not be part of the main purpose of the restrictive covenant".

On the other hand, if the non-competition agreement was made between a buyer and seller in the context of a business sale, the courts will more readily use the severance to preserve the core of the protection. The doctrine of severability is thus less likely to be applied to restrictive covenants negotiated between employer and employee. The primary rationale for this difference in judicial approach is the perceived imbalance of power between the employee and the employer (*ACS Public Sector Solutions Inc v Arntsen*, 48 B C L R (4th) 328, [2005] B C J No. 2656 (QL) at paras 37 and 50 (CA) (ACS cited to B C J)).

Notional severance and its applicability to restrictive covenants in employment contracts

Seven years ago the majority of the Supreme Court of Canada (Supreme Court) revamped the rules concerning judicial discretion when dealing with illegal contract clauses. In a criminal interest rate case, the Supreme Court broadened the spectrum of remedies available to a court dealing with an illegal contractual provision to include "notional severance" (*Transport North American Express Inc v New Solutions Financial Corp*, [2004] 1 S C R 249 at paras 32-33 (*Transport North American Express*)). A Canadian court can now actually alter the language of the agreement, rather than simply striking out the offending provisions.

The idea behind notional severance is that the court should adopt the technique that, in light of the particular contractual context involved, would most appropriately cure the illegality while otherwise preserving, as much as possible, the parties' intentions as expressed in the agreement. Therefore, the court's remedial discretion includes the ability to rewrite the illegal provision by deleting some words and inserting new ones.



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The rationale applied in the *Transport North American Express* case took note of the fact that the blue pencil technique may not necessarily achieve a rational result. The change effected by the blue pencil technique often fundamentally alters the consideration associated with the bargain and does violence to the intention of the parties. It was stated in the judgment that “although the results obtained from the blue pencil approach will in many cases be sensible and may often be desirable, due to its artificiality, the application of the blue pencil approach will sometimes be inappropriate” (*Transport North American Express*, at para 33).

In 2007, the Supreme Court overturned *KRG Insurance Brokers (Western) Inc v Shafron* (2007) B C C A 79, [2007] B C J No. 261, (QL) (*KRG*), in which the British Columbia Court of Appeal (B C C A) had applied the “notional severance” rule in the context of an employment contract. In the *KRG* case, Shafron worked for KRG under a series of agreements, each of which contained non-competition covenants that prohibited Shafron from competing with KRG in the “Metropolitan City of Vancouver” for three years following the termination of employment. Shafron left KRG and accepted a position with another insurance agency in Richmond, B C. The B C C A found that the covenant was reasonable in terms of temporal length, spatial area covered, nature of activities prohibited and overall fairness, but the term Metropolitan City of Vancouver was uncertain. The court decided to apply notional severance and delete the uncertain term and replace it with the “City of Vancouver, University of British Columbia Endowment Lands, Richmond and Burnaby”.

The Supreme Court reversed the judgment of the B C C A in *KRG* in the *Shafron* case and decided that notional severance cannot be used where the court is dealing with a restrictive covenant in an employment contract. While the Supreme Court left open the possibility of using notional severance in relation to a restrictive covenant in a business sale agreement, the judgment contains statements which indicate that a court may very well refuse to apply notional severance in a commercial non-competition agreement because with restrictive covenants (unlike criminal interest rate matters), there is no “bright line test for reasonableness”.

Moreover, the Supreme Court held that an unreasonable or ambiguous restrictive covenant in an employment contract will generally be void and unenforceable.

Descending scope clauses

Descending scope clauses are designed to encourage courts to use blue pencil severance so that an employer obtains maximum protection. For example, a descending scope clause may prohibit competition in:

- Canada.
- Saskatchewan.
- The City of Saskatoon.

The theory is that if the court believed a Canada-wide prohibition to be too broad, it could strike out that word, but leave the rest. While that approach may be adopted by some US courts, in light of the Supreme Court requirement in *KRG* that the courts use blue pencil severance as regards trivial matters that are not part of the main purport of the restrictive covenants, at least one judge has already said that *KRG* “sounds the death knell for descending scope covenants” (*Bonazza v Forensic Investigation* [2009] O J No. 2626).

Over-reaching: the risks involved

Because Canadian courts, unlike many US courts, will not rewrite or write down an unenforceable provision and will only apply severance sparingly in relation to a trivial point (*see above*, *Judicial trends: Traditional approach: strike down or blue pencil severance*), Canadian courts encourage employers and their investors to strive to ensure that non-competition terms are clear, unambiguous, reasonable and do not over-reach. The penalty for over-reaching was illustrated by the Ontario Court of Appeal in *IT/NET Inc v Cameron* (207 O A C 26, [2006] O J No. 156 (QL) (CA)) (*Cameron*): a subcontractor had breached a non-solicitation/non-competition provision when he left IT/NET to help its competitor successfully bid for work from the very same government department for which the subcontractor had done work on behalf of IT/NET. The clause provided, in part, that for a period of 12 months after termination, Cameron would “not attempt to solicit business from any IT/NET clients or prospects” (*Cameron*, para 6).

In *Cameron*, the court found the provision to be unenforceable because it prevented a contractor from soliciting business from any IT/NET client or prospect, not just from the client with whom the contractor had worked.

The court acknowledged that IT/NET did have a legitimate interest to protect and the court would have enforced a clause that prohibited Cameron from doing what he had done (that is, help a competitor solicit business from the very client Cameron had serviced on behalf of IT/NET), but, nevertheless, struck down the entire clause. In doing so, the court acknowledged it was permitting Cameron to take “unfair advantage of the links he had been permitted to develop with the client because of the relationship IT/NET had nurtured with that client” (*Cameron*, para 16).

DRAFTING AN ENFORCEABLE RESTRICTIVE COVENANT

In light of these decisions, business investors and employers should keep the following points in mind when drafting key employee restrictive covenants:

- Where a key employee will be working very closely with a single client (for example, as part of a secondment or on a specific project), the employer may want to use a more precise covenant (for example, which specifies that the employee cannot solicit work from, or be employed by, a client with whom he has worked or had personal contact) to bolster the chance of it being found enforceable by a court and, thereby, preventing the employee from capitalising on acquired knowledge and goodwill.
- At the same time, employers should ensure that any restrictive covenant is not drafted in such a narrow and specific fashion as to require new covenants to be executed each time the employee starts to work for a new client.
- If the key employee is also party to a commercial agreement, such as an agreement of purchase and sale or even a shareholders’ agreement, the restrictive covenant should be contained in that commercial agreement.
- It is advisable to record in the contract any factors which illustrate a balance of bargaining power.



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ONTARIO APPROACH: NON-COMPETITION AS A CONDITION FOR A BENEFIT

A business has greater flexibility when using non-competition undertakings as consideration for employment or post-employment benefits. Where the business merely retracts the benefits when the key employee competes (rather than seeking to prevent the competition outright) they may not need to establish that the non-competition covenant is reasonable. Two Ontario courts have held that an employer will not need to establish that the non-competition agreement is reasonable in these circumstances, because it does not actually restrain competition.

In *Woodward v Stelco Inc* ((1998), 80 C P R (3d) 319) (*Stelco*) the Ontario Court of Appeal ruled that a promise not to compete in exchange for supplementary executive retirement benefits was not a contract in restraint of trade, and therefore the common law requirements of reasonableness did not apply. The court's rationale was that the promise not to compete did not restrain trade because the executive could have competed, except that by doing so he would lose the right to the supplementary retirement benefits.

The *Stelco* principle was extended in *Nortel Networks v Jervis* ((2002), 33 C C P B 71, [2002] O J No. 12 (QL) (Ont Sup Ct)) where another Ontario court enforced a non-competition promise in a stock option plan. The executive agreed that if, within a year of executing options, he competed with the company, he would have to repay to the company the profit he made on the exercise of those options. In this case, the court concluded that the employee was required to repay his profits because the contract did not restrain trade (that is, he could compete, but if he did so he was required to repay the profits from the option exercise).

To take advantage of the above approach, Ontario based businesses should:

- Assess the benefits they are prepared to provide executives during and after employment.
- Determine whether any benefits should be conditional on compliance with a non-competition covenant.
- Determine if there are any available and practical repayment options in the event of improper competition.
- Ensure that any repayment obligation is not oppressive or unconscionable.

QUÉBEC APPROACH

Unique among Canadian provinces, Québec courts rely on the Québec Civil Code (Code) and not the common law rules applicable in the rest of Canada. The general idea under the Code concerning employee restrictive covenants is similar to the common law requirements: the employer must establish that restrictive covenants are reasonable "as to time, place and type of employment" (*section 2089, Code*). However, there are some specific approaches to restrictive covenants in Québec:

- Because an employer cannot rely on an employment contract which it has breached (*section 2095, Code*), the Québec courts might not enforce a restrictive covenant after the employer has terminated the employee's employment without cause. In practice, Québec employers may require the dismissed key employee to sign a fresh restrictive covenant as a condition of any severance package.
- Québec courts will not apply blue pencil severance (*Drouin v Surplec Inc* [2004] R J Q 1125 (Que CA)).
- While the concept of consideration does not anchor contract law under the Code the way it does in common law jurisdictions, Québec courts may assess the benefits the key employee received in determining the reasonableness of the restrictive covenant.

RESTRICTIVE COVENANTS: THE OVERALL PICTURE

The legal treatment of employment restrictive covenants reflects the Canadian legal system's desire to be fair to both parties and to encourage competition and economic development while protecting legitimate, clearly expressed business interests. As such, the case law can lead to results which are not entirely consistent. However, the general policy is to encourage employers and their investors to carefully draft modest restrictive covenants, because restrictive covenants in the employment context are subject to greater scrutiny than those in a commercial setting.

Notably, and fortunately for the employers, no Canadian jurisdiction adopts the California approach that non-competition clauses are simply unenforceable. Therefore, while they may be difficult to enforce, there always remains the scope for argument.

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