Litigation - Canada

Enforceable non-compete clauses in business sales: the analytical framework

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Introduction

Buyers and sellers of businesses in Canada should be aware of an established body of case law in respect of non-compete clauses, or covenants in restraint of trade. In connection with the sale of a business in Canada, a non-compete clause operates largely to protect the purchaser. Immediate competition by the seller could harm the purchaser's new business, and thus render it of no value or significantly impair it. Recently in *Payette v Guay inc*(1) the Supreme Court of Canada underscored its contextual and pragmatic approach to the interpretation of non-compete agreements. The Supreme Court also confirmed that different interpretive principles are brought to bear depending on whether the clause is found in a commercial transaction or in an employment contract.(2)

This update examines the analytical framework with respect to the enforceability of non-compete clauses in contracts for the sale of a business. It first provides an overview of the test to establish a valid non-compete agreement. It then focuses on the essential elements of the courts' analysis of restraint on trade covenants and reviews the interpretation of non-compete clauses in the context of the sale of a business. It also discusses the concept of severance when a non-compete clause is held to be unreasonable.

Analytical framework: *JG Collins Insurance Agencies Ltd v Elsley*

A non-compete clause is a demanding covenant in restraint of trade. As the Ontario Superior Court of Justice indicates, a non-compete clause "precludes a contracting party from engaging in a business that competes with the business of the other contracting party".(3) It is a longstanding tenet of the common law that covenants in restraint of trade are *prima facie* invalid as being contrary to public policy.(4)

However, the courts have recognised the need to balance two competing public policy interests – on the one hand, the policy of promoting free and open competition in the marketplace, while on the other, the policy of maintaining freedom of contract.(5)

The leading decision on the enforceability of a restrictive covenant is that of the Supreme Court of Canada in *JG Collins Insurance Agencies Ltd v Elsley*,(6) which built on the principles established by the House of Lords in *Nordenfelt v Maxim Nordenfelt Guns & Ammunition Co Ltd*.(7) According to the Supreme Court in *Elsley*, "[a] covenant in restraint of trade [such as a non-compete clause] is enforceable only if it is reasonable between the parties and with reference to the public interest".(8) This is a contextual analysis as the "test of reasonableness can be applied… only in the peculiar circumstances of the particular case".(9)

The Supreme Court enumerated a three-step inquiry for assessing the reasonableness of the non-compete clause as it pertains to the parties:

- Does the plaintiff have a proprietary interest entitled to protection?
- Are the temporal or spatial features of the clause too broad?
- Is the covenant unenforceable as being against competition generally and not limited to proscribing solicitation of clients?(10)

Once the party relying on the restrictive covenant has demonstrated that it is reasonable

between the parties to the contract, the onus of proving that it is contrary to public interest rests with the party challenging its validity.(11)

Although *Elsley* remains the leading decision, the case of *KRG Insurance Brokers (Western) Inc v Shafron*(12) has provided an important addition.(13) In *KRG* the Supreme Court held that "[a]n ambiguous restrictive covenant", especially one contained in an employment contract, "will be *prima facie* unenforceable because the party seeking enforcement will be unable to demonstrate reasonableness in the face of an ambiguity".(14)

Non-compete clause must be reasonable

Ambiguity

If a non-compete clause is ambiguous "in the sense that it does not clearly define the prohibited activities, the territory of its operation, and the time of its operation, it is unreasonable and unenforceable".(15) In other words, according to the Alberta Court of Appeal, "[i]f the meaning of a restrictive covenant cannot be ascertained", the court should not enforce it.(16)

In *KRG* the restrictive covenant in an employment contract applied to the "Metropolitan City of Vancouver". The Supreme Court held that the phrase 'Metropolitan City of Vancouver' was ambiguous because it was not a legally defined term and evidence suggested that the parties did not possess a mutual understanding regarding the geographic area to which the covenant applied.(17)

In *Duncan Sabine Collyer Partners LLP v Campbell*(18) the Manitoba Court of Queen's Bench determined that the non-compete clause in an employment contract was ambiguous as the use of the term 'client' was defined by the present tense. According to the court:

> "*[t]he purpose of the clause is to protect the [employer's] interest in their current customers forward into the future. To do this, the clause must connect the current proprietary interest therein forward. The subject clause does not accomplish this.*"(19)

Proprietary interest

The party seeking to enforce the non-compete clause must demonstrate a legitimate proprietary or business interest. The courts will not recognise a restrictive covenant that simply prohibits another party from participating in an industry.(20) In *Vancouver Malt and Sake Brewing Company v Vancouver Breweries*,(21) for example, the Privy Council held that:

> "*covenants restrictive of competition which have been sustained have all been ancillary to some main transaction, contract, or arrangement, and have been found justified because they were reasonably necessary to render that transaction, contract, or arrangement effective.*"(22)

Indeed, the case law suggests that typical proprietary interests which will be protected in the context of commercial transactions include the goodwill of a business and the value of trade secrets.(23)

Temporal or spatial features

The temporal or spatial features of a non-compete clause must not be too broad. In *Martin v ConCreate USL Ltd Partnership*(24) the Ontario Superior Court of Justice stated that, "[a]s a general rule, in determining reasonableness, courts will consider three elements: (1) the extent or scope of the activities prohibited; (2) the territory covered by the covenant; and (3) the duration of the prohibition".(25)

Whether the temporal or spatial features of a non-compete clause are reasonable depends, in large part, on the type of business involved. The restraint of trade must not be any greater than is required to protect the interests of the party in favour of whom the covenant is granted.(26)

A reasonable temporal restriction will vary in accordance with the time required for a party to rebuild its customer relationships and stabilise its new business operations.(27) For example, in *Dale & Co v Land*(28) the Alberta Court of Appeal held that a five-year non-compete clause on the sale of an insurance business "must be measured against what appears to be the unique ability of the appellant to retain the loyalty of his clientele".(29)

Similarly, what constitutes a reasonable spatial area is informed by the region in which a particular company conducts business. In *Tank Lining Corp v Dunlop Industries Ltd*(30) the Ontario Court of Appeal confirmed that "if a business is confined to a small area, a purchaser cannot enforce a non-competition clause covering a much wider area".(31)

Evaluating the temporal or spatial features of a restrictive covenant is ultimately a contextual inquiry. In *Connors Brothers Ltd v Connors*(32) the respondent sold the controlling interest of a sardine canning company and promised not to engage in any

other sardine business in the Dominion of Canada for a period of 10 years. Although the company was situated in New Brunswick, it shipped cases of sardines across the provinces.(33) Consequently, the Privy Council determined that the restraint of trade was reasonable.

In *Cope v Harasimo*(34) the British Columbia Court of Appeal held that a restrictive covenant to endure for the vendor's lifetime in Campbell River was valid with respect to the sale of a hairdressing business.(35) Due to the personal nature of the hairdressing profession, the court regarded the non-compete clause as reasonable.(36)

In *Dyform Engineering Ltd v Ittup Hollowcore International Ltd*(37) the British Columbia Court of Appeal considered the validity of an eight-year global non-compete clause in relation to the manufacture or sale of concrete equipment. In light of the parties' intentions, as well as the nature of the business and investment of capital, the court concluded that the non-compete clause was reasonable.(38)

Against competition generally
To be enforceable, a non-compete clause must not be against competition generally. If a non-solicit clause would have adequately protected the interests of the party, then a non-compete agreement may be considered unreasonable.(39) This inquiry is particularly important in the context of employment law. As the Supreme Court indicated, "[w]hether a [non-compete] restriction is reasonably required for the protection of the covenantee can only be decided by considering the nature of the covenantee's business and the nature and character of the employment".(40)

In *Lyons v Multari*(41) a non-compete clause limited a junior oral surgeon from practising his profession if he chose to leave his employer's dental office. The Ontario Court of Appeal considered the relationship between non-solicit and non-compete clauses in the context of a professional employment contract. According to the appeal court:

> "*[t]he non-competition clause is a more drastic weapon in an employer's arsenal. Its focus is much broader than an attempt to protect the employer's client or customer base; it extends to an attempt to keep the former employee out of the business.*"(42)

The appeal court held that, on the facts, a non-solicit clause would have adequately protected the employer's interests. Therefore, the non-compete clause was excessive and unenforceable for the following reasons:

- The employer had no proprietary interest in people who were not actual or potential patients;
- Both the employer and the employee benefited from their professional association;
- The role of the employee did not rise to a level where patients considered him to be the personification of the dental practice;
- The employee was not privy to confidential information or trade secrets; and
- The employer's restrictive covenant did not uniformly accord with the standard professional practice.(43)

Non-compete clause must not be contrary to public interest
A valid non-compete clause must also be reasonable with reference to the public interest. If the restrictive covenant is reasonable as between the parties, the burden shifts to the party challenging the clause to demonstrate that the agreement is contrary to the public interest.(44) Indeed, this part of the analysis "recognizes that the assertion of a private right can create a public wrong".(45)

The restrictive covenant will be ruled unenforceable where it confers market dominance on a particular party or violates the Competition Act(46) (Canada).(47) The Ontario Court of Appeal has confirmed that the doctrine of public interest is broad and should provide protection against circumstances in which "[t]he cessation of business might… deprive the nation or a region of an essential industry, an important source of wealth and employment or vital technology".(48)

Non-compete clauses in sale of business

According to Angela Swan and Jakub Adamski, "[t]he key to the modern law lies in the fact that the courts have drawn a sharp distinction between cases where the restraint is imposed on the seller of a business and those where it is imposed on an employee".(49) As indicated in the seminal *Nordenfelt* case, "there is obviously more freedom of contract between buyer and seller than between master and servant or between an employer and a person seeking employment".(50)

Consider, for example, the carefully reasoned decision of the Supreme Court of Canada in *Elsley*:

> "*The distinction made in the cases between a restrictive covenant contained in an agreement for the sale of a business and one contained in a contract of*

> *employment is well-conceived and responsive to practical considerations. A person seeking to sell his business might find himself with an unsaleable commodity if denied the right to assure the purchaser that he, the vendor, would not later enter into competition. Difficulty lies in definition of the time during which, and the area within which, the non-competitive covenant is to operate, but if these are reasonable, the courts will normally give effect to the covenant.*
>
> *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.*"(51)

Consequently, the courts are more inclined to enforce a non-compete clause in the commercial context. In *Rogers Communications Inc v Shaw Communications Inc*(52) the Ontario Superior Court of Justice suggested that "[p]arties of equal bargaining strength such as Rogers and Shaw acting with legal advice... [are]... the best judges of what is reasonable as between them".(53)

More recently in *Payette*, a case involving the interpretation of restrictive covenants in an agreement for the sale of assets, the Supreme Court confirmed that:

> "*the common law rules for restrictive covenants relating to employment do not apply with the same rigour or intensity where the obligations are assumed in the context of a commercial contract. This is especially true where the evidence shows that the parties negotiated on equal terms and were advised by competent professionals, and that the contract does not create an imbalance between them.*"(54)

In that case, the appellant Yannick Payette and his partner sold the assets in their crane rental business to the respondent, Guay inc. During the transition, the appellants agreed to work for the respondent company as consultants for a period of six months. The asset purchase agreement contained both non-compete and non-solicit clauses. Following Payette's dismissal from Guay inc, he was hired as an operations manager at a competing company, Mammoet Crane Inc. The respondent sought an injunction ordering Payette to comply with the restrictive covenants in the asset purchase agreement by not accepting employment with Mammoet Crane Inc.

The Supreme Court observed that the agreement for the sale of assets was a hybrid contract – that is, the agreement gave rise to two separate juridical actions: the commercial contract and the employment contract.(55) According to the Supreme Court:

> "*To determine whether a restrictive covenant is linked to a contract for the sale of assets or to a contract of employment, it is… important to clearly identify the reason why the covenant was entered into. The 'bargain' negotiated by the parties must be considered in light of the wording of the obligations and the circumstances in which they were agreed upon. The goal of the analysis is to identify the nature of the principal obligations under the master agreement and to determine why and for what purpose the accessory obligations of non-competition and non-solicitation were assumed.*"(56)

This process is an exercise in contractual interpretation which emphasises both the terms of the agreement and the factual context that explains why the obligations were assumed.

The evidence established that Payette's acceptance of the non-compete and non-solicit clauses related to the contract for the sale of assets rather than the contract of employment. The restrictive covenants could not be disassociated from the asset purchase agreement.(57) As a result, the Supreme Court held that the agreement should be interpreted in the commercial context whereby "a restrictive covenant is lawful unless it can be established on a balance of probabilities that its scope is unreasonable".(58)

Severance

It is the standard practice of many solicitors drafting corporate and commercial contracts to include a section which provides that any illegal or unenforceable provisions shall be severed from the rest of the agreement. In the context of an unreasonable non-compete clause, the parties may ask the court to sever the offending portion of the clause. However, this remedy is not available where the impugned contract does not contain a severance provision.(59) There are two methods of severance: blue-pencil severance and notional severance.(60)

Blue-pencil severance is appropriate only "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".(61) Judges will exercise a great deal of caution in their application of this remedy because "when a court employs the blue-pencil test, it is making a new agreement for the parties".(62) In *Blunt v De Palma*(63) the British Columbia Supreme Court considered a complex non-compete agreement contained in a contract for the sale of a denturist business. The restrictive covenant was drafted as a series of descending temporal and spatial limitations, which the plaintiff argued was unenforceable on the basis of uncertainty. The court described the covenant "as a legal version of 'Russian Dolls' where when the outer one is removed there remains a lesser one that contains in itself even lesser ones".(64) The court recognised the parties' severance clause and held that any unreasonable temporal or spatial restrictions could be struck out accordingly.

Notional severance involves reading down an unreasonable restrictive covenant in order to give effect to the proper intention of the parties.(65) In *Transport North American Express Inc v New Solutions Financial Corp*,(66) a case involving an excessive rate of interest under the Criminal Code, a majority of the Supreme Court applied the concept of notional severance to reduce the amount of interest to 60%.(67) Swan and Adamski suggest that:

> "*[i]t would make some sense to apply this concept to the restrictions contained in non-competition clauses, though only to those given by the sellers of businesses. So far such courts as have considered the matter have rejected notional severance in the context of restraints on trade.*"(68)

Comment

In *Elsley* the Supreme Court held that a non-compete clause – or a covenant in restraint of trade – is enforceable only if it is reasonable between the parties and with reference to the public interest. Whether a non-compete clause is reasonable between the parties depends on the questions set out above.

If the party relying on the non-compete clause has demonstrated its reasonableness as it pertains to the contracting parties, the burden of proof shifts to the challenging party, which must demonstrate that the clause is nevertheless against the public interest.

The jurisprudence draws a clear distinction between cases where a non-compete clause is included in a contract for the sale of a business and where it is included in a contract of employment. In circumstances involving a hybrid contract, as in *Payette*, the court's inquiry focuses on principles of contractual interpretation and the reasons why the restrictive covenant was entered into. In the corporate and commercial context, the courts have repeatedly held that parties of equal bargaining strength acting with independent legal advice are capable of protecting their respective interests. Where the terms of a restrictive covenant are unambiguous and meet the above criteria, the courts will typically give effect to the non-compete clause.

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Endnotes

(1) *Payette v Guay inc*, 2013 SCC 45.

(2) *Ibid* at para 2.

(3) *Martin v ConCreate USL Ltd Partnership*, 2012 ONSC 1840, 348 DLR (4th) 526, 2012 CarswellOnt 3701 at para 5.

(4) Angela Swan and Jakub Adamski, *Canadian Contract Law*, 3d ed (Markham, ON: LexisNexis Canada Inc, 2012) at § 9.253.

(5) *JG Collins Insurance Agencies Ltd v Elsley*, [1978] 2 SCR 916, 83 DLR (3d) 1, 1978 CarswellOnt 1235 at para 13.

(6) *Ibid*.

(7) *Nordenfelt v Maxim Nordenfelt Guns & Ammunition Co Ltd*, [1894] AC 535.

(8) *Elsley*, *supra* note 5 at para 13.

(9) *Ibid*.

(10) *Ibid* at para 19.

(11) *Ibid* at para 26.

(12) *KRG Insurance Brokers (Western) Inc v Shafron*, [2009] 1 SCR 157, 301 DLR (4th) 522, 2009 CarswellBC 79.

(13) Geoff R Hall, *Canadian Contractual Interpretation Law*, 2d ed (Markham, ON: LexisNexis Canada Inc, 2012) at 318.

(14) *KRG*, *supra* note 12 at para 27.

(15) *Martin*, *supra* note 3 at para 25.

(16) *Globex Foreign Exchange Corp v Kelcher*, 2011 ABCA 240, 48 Alta LR (5th) 215, 2011 CarswellAlta 1356 at para 20.

(17) *KRG*, *supra* note 12 at paras 57-58.

(18) *Duncan Sabine Collyer Partners LLP v Campbell*, 2011 MBQB 302, 272 Man R (2d) 234, 2011 CarswellMan 656.

(19) *Ibid* at para 54.

(20) Richard D Leblanc and David Reynolds, "Drafting Enforceable Non-Compete Covenants" (2011) 20:8 *Canadian Corporate Counsel* 116 at 117.

(21) *Vancouver Malt and Sake Brewing Company v Vancouver Breweries*, [1934] AC 181.

(22) *Ibid* at 190.

(23) *Tank Lining Corp v Dunlop Industries Ltd* (1982), 40 OR (2d) 219, 140 DLR (3d) 659, 1982 CarswellOnt 780 at paras 15-16; see also Leblanc and Reynolds, *supra* note 20 at 117.

(24) *Martin*, *supra* note 3.

(25) *Ibid* at para 31.

(26) *McAllister v Cardinal*, [1965] 1 OR 221, 47 DLR (2d) 313, 1964 CarswellOnt 169 at para 9.

(27) Leblanc and Reynolds, *supra* note 20 at 117-118.

(28) *Dale & Co v Land* (1987), 56 Alta LR (2d) 107, 84 AR 52, 1987 CarswellAlta 249.

(29) *Ibid* at para 9.

(30) *Tank Lining*, *supra* note 23.

(31) *Ibid* at para 25; see also *Cardinal*, *supra* note 26 at para 9.

(32) *Connors Brothers Ltd v Connors*, [1941] 3 WWR 666, [1940] 4 All ER 179, 1940 CarswellNat 46.

(33) *Ibid* at para 38-39.

(34) *Cope v Harasimo* (1964), 50 WWR 639, 48 DLR (2d) 744, 1964 CarswellBC 202.

(35) *Ibid* at para 9.

(36) *Ibid*.

(37) *Dyform Engineering Ltd v Ittup Hollowcore International Ltd*, [1985] BCWLD 1699, 19 BLR 1, 1982 CarswellBC 473.

(38) *Ibid* at paras 87-91.

(39) Leblanc and Reynolds, *supra* note 20 at 118.

(40) *Elsley*, *supra* note 5 at para 19.

(41) *Lyons v Multari* (2000), 50 OR (3d) 526, 3 CCEL (3d) 34, 2000 CarswellOnt 3186.

(42) *Ibid* at para 31.

(43) *Ibid* at paras 39-47.

(44) *Elsley*, *supra* note 5 at para 26.

(45) *Tank Lining*, *supra* note 23 at para 36.

(46) Competition Act, RSC 1985, C-34.

(47) *Tank Lining*, *supra* note 23 at para 40; see also *Martin*, *supra* note 3 at para 37.

(48) *Tank Lining*, *supra* note 23 at para 46; see also GHL Fridman, *The Law of Contract in Canada*, 6th ed (Toronto: Carswell, 2011) at 397-398.

(49) Swan and Adamski, *supra* note 4 at § 9.260.

(50) *Nordenfelt*, *supra* note 7 at 566.

(51) *Elsley*, *supra* note 5 at paras 15-16.

(52) *Rogers Communications Inc v Shaw Communications Inc*, 2009 CanLII 48839.

(53) *Ibid* at para 39.

(54) *Payette*, *supra* note 1 at para 39.

(55) *Ibid* at para 44.

(56) *Ibid* at para 45.

(57) *Ibid* at para 46.

(58) *Ibid* at para 58.

(59) *Martin*, *supra* note 3 at para 42.

(60) *Ibid* at para 44.

(61) *Transport North American Express Inc v New Solutions Financial Corp*, 2004 SCC 7, [2004] 1 SCR 249, 2004 CarswellOnt 512 at para 57, Bastarache J, dissenting.

(62) *Ibid* at para 30.

(63) *Blunt v De Palma*, 2005 BCSC 992, 11 BLR (4th) 294, 2005 CarswellBC 1639.

(64) *Ibid* at para 59.

(65) *Martin*, *supra* note 3 at para 44.

(66) *Transport*, *supra* note 61.

(67) *Ibid* at para 47.

(68) Swan and Adamski, *supra* note 4 at § 9.270.