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RESTRICTIVE COVENANTS-
VALID AND VALUABLE, OR A WASTE OF PAPER?

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Restrictive Covenants-Valid and Valuable, or A Waste of Paper?

Introduction

Employers are more sensitive to the need to protect company confidential information, technology and strategies than ever before. There are a number of reasons for the trend; this paper focuses on what appear to me to be the most salient reasons.

Employees working from home offices or other remote locations are no longer the exception. A business in Alberta for example, may engage sales agents to work in locations where no corporate office exists. Flexible work schedules and state of the art technology allow workers greater independence. For employers, these changes mean that their employees may become not only the face of the business, but the main or exclusive client contact.

Especially in knowledge based industries, it is progressively easier and more lucrative for an existing or former employee to set up a competing business. With the sophistication of information systems, employees and former employees can easily save or re-create customer lists and other sensitive information from home. Workers appear to be less intimidated by the prospect of being sued by their former employers. They are more educated about their rights and are very aware of the costs and hurdles that their former employers may face in court in attempting to restrict their competition.

Employers are at risk in this competitive market from former employees at all ranks - not only senior management or key employees. Workers in some sectors are acutely aware of their marketability and their negotiating power. Employers recognize this too and are increasingly inclined to forego the requirement of employment agreements containing non-competition or non-solicitation clauses in order to attract top candidates for the job. For employers who do require these agreements as a term of employment, the restrictive covenants contained in them are often worth little more than the paper they are written on. These clauses, time and again, are found to be unenforceable because they are overly broad.

Well informed workers are sometimes unafraid to sign agreements containing offensive restrictive covenants because they know that the covenants will not stand up in court. Where the prospect of a court injunction to enforce a restrictive covenant used to frighten a departing employee, it may not do so today. Enforcement of restrictive covenants is difficult in the strict employment context.

Employers are engaging legal counsel, not only to draft the covenants, but to assist them to develop exit strategies to reduce the risk of competing former workers. More and more, employers recognize the need to be proactive.

In my view, there is a far greater need today for sophisticated legal advice, both for workers and employers, concerning the protection of confidential information, client base, goodwill and the corresponding rights of employers and workers.

Much has been written about the enforceability of restrictive covenants. In this paper and in my presentation, my aim is to delve into basics and to pinpoint the main legal principles arising from the jurisprudence about the enforceability of restrictive covenants in the strict employment context. I will

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also attempt to identify trends and to provide practice tips for reviewing and drafting restrictive covenants.

Common Law Duty of Good Faith of Former Employees

At common law, absent any express contractual term, certain classes of former employees will not be at liberty to act in an unfair way to a former employer. In appropriate circumstances, a former employee may be found to have breached an enforceable duty owed to a former employer and may be successfully sued for injunctive relief or for damages.

A broad line of authority imposes employment fiduciary obligations on various levels of employees, even low level employees if the employer is particularly vulnerable to post-employment solicitation. A more restrictive line of cases holds that a worker is not a fiduciary unless he or she is truly "top management". Unfortunately for employers, the latter seems to be the category more likely to be applied by the courts in BC.

The B.C. Court of Appeal has reasoned that a person who may be characterized as top management or a key employee on the basis of the functions and duties performed, may be precluded from soliciting a former employer's business, however, an ordinary employee may compete with a former employer, subject to the caveat that he or she may not make use of the employer's confidential information such as physical or electronic customers lists.'

The *Valley First* decision involved a Vernon insurance salesman who had started a business that competed with that of his former employer. The trial judge had determined that the non-competition and non-solicitation covenants found in the salesman's contract were unenforceable as they were unreasonable as between the parties, were an unreasonable restraint of trade and contrary to the public interest. He dismissed the claim of breach of fiduciary duty on the basis that the employees involved were not fiduciaries. He concluded instead that the employees had breached their common law duty of fidelity.

On appeal, notwithstanding evidence that a majority of the book of business left with the departing employees, the Court of Appeal concluded that none of the employees fell within the class of senior employees nor did they remove any proprietary information. Rather, they relied upon their collective memory. The Court of Appeal concluded that the employer had known the risk it was running and had attempted to protect itself with non-competition and non-solicitation covenants. But it had overreached. By overreaching and creating unenforceable restrictions, the employer forfeited any ability to impose a duty of fidelity upon ordinary staff:

> former employee, other than a senior or key employee with fiduciary-like obligations, is free to compete with his or her former employer and to make use of the knowledge and experience acquired while employed so long as he or she does not disclose or make use of the former employer's confidential information, including customer lists removed from the former employer's premises. However, a former employee is entitled to solicit customers of the former employer recalled from his or her memory..."[2]

The case exhibits the B.C. court's. reluctance to restrain trade. The reality, however, of industries such as the insurance industry or software development, is that former employees do not need to take lists with them when they depart. Customer information is likely readily available to them on the internet.

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[1] *Valley First Financial Services Ltd. V. Trach, [2004} B.CCA.* 312, 30 *B.C.L.R.* (4th) 73,198 *B.CA.C 261*
[2] *Ibid..*'at paragraph 72

Particularly in smaller communities, information regarding client preferences and needs may be well ingrained in the departing employee's memory.

Even in cases where departing employees behave in the most flagrant manner, the B.c. courts tend to stand firm in distinguishing between senior employees and employees with less responsible roles. One such case is a recent B.C. Supreme Court decision" where former employees behaved in such a brazen manner post termination, that the Court could have justifiably expanded its traditional common law approach. In the decision *RBC Dominion Securities Inc. v. Merrill Lynch Canada Inc,* the Court seemed to struggle, trying to attach liability to these former employees within the strict common law parameters. The decision ultimately exemplifies just how far former employees can go to compete with and harm their former employers in the absence of an enforceable contract of employment.

The Plaintiff, RBC Dominion Securities Inc. ("DS") and the Defendant, Merrill Lynch Canada Inc. ("ML") were both securities and investment dealers. Each had a branch in Cranbrook, BC, that was the other's main competition. In November of 2000, the branch manager of DS and almost the entire sales force of DS's Cranbrook and Nelson offices left to join ML, leaving behind only two very junior investment advisors ("lAs"), an office administrator and a receptionist.

The issue before the Court was the extent of fiduciary or other duties of the DS branch manager, Don Delamont, and of the other employees and lAs who had left DS and the responsibility of ML and its regional manager in relation to those departures. DS alleged that Mr. Delamont owed fiduciary duties to DS and other duties inherent in his employment that he had violated by leading the group departure and soliciting DS clients away to ML. DS alleged that the other lAs shared in Delamont's breaches of fiduciary duty and that, because they left as virtually the "whole show," they owed higher duties to DS than if they had left individually. Finally, DS alleged that ML and its manager induced the various breaches.

The Defendants of course denied any fiduciary relationships with DS. They argued that DS, a sophisticated employer, made a conscious decision not to expressly stipulate non-competition or non-solicitation terms to apply on the employees' departure and that DS could not ask the Court to find such restrictions inherent in the employment relationship.

In coming to its conclusion that these employees could fairly compete, the Court noted that some lAs, about ten to fifteen percent of those hired at DS, were "competitive hires" or experienced lAs recruited from other firms. The Court noted that competitive hiring was common place and aggressive and was seen as necessary to a securities firm's growth. Indeed, firms provided financial incentives and rewards to lAs who achieved or assisted in brining in a competitive recruit.

In this case, the Court decided that the aggressive recruiting went above and beyond that which was appropriate. The departing employees secretly removed or copied (and sent to ML), DS's client records. A team of ML's staff used the DS records to prepare to move these clients to ML. This process was complete well before DS learned of the departing employees' plans. These facts seemed to make the Court desirous of imposing some liability upon the departing employees.

In its decision, the B.C. Supreme Court affirmed the general duty not to compete unfairly. More restrictions apply to a former employee in a fiduciary relationship to the employer. Like a non-fiduciary employee, he or she may compete fairly against the former employer. However, he or she must in addition not directly solicit the former employer' clients."

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[3] *RBC Dominion Securities Inc. v. Merrill Lynch Canada Inc.,* [2003] B.C,J. No. 2700; supplemental reasons at [2004] B.C,J. No. 2337 and [2005] B.C,J. No. 1925

[4] *Ibid.,* at paragraph 36

Citing from the Supreme Court of Canada decision in *Frame* v. *Smith*[5] the Court in DS set out the key features of a fiduciary relationship:

> "Relationships in which a fiduciary obligation have been imposed seem to possess three general characteristics:
>
> I. The Fiduciary has a scope for exercising some discretion or power.
>
> 2. The Fiduciary can unilaterally exercise that power or discretion so as to affect the beneficiaries legal or practical interests.
>
> 3. The Beneficiary is peculiarly vulnerable to or at the mercy of the Fiduciary holding the discretion or power. „6

With these principles in mind, the Court did not find a basis in law for the broad proposition that because the lAs were key to the functioning of the branch that they were for that reason alone in a fiduciary relationship with DS. The Court reached a similar conclusion in relation to other aspects of the lAs roles and DS's vulnerability. The Court could not conclude that this situation was susceptible to the type of exploitation against which the fiduciary relationship protects. The Court further determined that, even if the departing employees were leaving as a group, that did not make them fiduciaries.

Mr. Delarnont, the manager, was not a fiduciary either. For that reason, it was unnecessary to consider whether the other lAs were to be fixed with any breaches of his fiduciary duties.

But that was not the end of the evaluation for the Court, because they likely determined it was necessary to impose some liability based upon the egregious manner in which these departing employees had behaved toward DS. This is the most notable aspect of this case. The Court focussed upon the departing employees' duty to provide reasonable notice of their departures.

The Court stated that it is an implied term of an employment contract that the employee will give reasonable notice of termination. In that industry, the evidence was that once an IA announced that he or she would be leaving for another firm, he or she was usually escorted off the premises immediately. These abrupt practices reflected the expectation of fierce competition for the clients who were part of the departing lAs' book. The Court determined that the significance of a period of notice is in the effect it would have had in preventing the departing employees from immediately competing with DS for the clients. The Court addressed the appropriate length of any such period and the larger examination of whether the lAs' competition for clients was fair.

The Court determined that the removal of client records was also without justification and allowed the departing employees to compete unfairly with DS. The Court concluded that the lAs' conduct extended far beyond the norm in that industry and amounted to a determined and frenetic campaign to move the clients to ML. The Court held that the simultaneous departure of virtually the entire staff of the Cranbrook branch had a much greater effect on DS than would have individual departures over a lengthy period of time. It was open to the employees to all leave at the same time as they did. However, in the Court's view, a planned group departure enhances the limitations inherent in the notion of fairness on the departing employees at liberty to compete directly with DF for its clients. The Court found the departures were a group undertaking. The employees competed unfairly with DS by taking part in the process by which DS's confidential client information was removed or copied and sent to ML and actively competing for DS's clients from a position that DS could not possibly match.

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5 *Frame v. Smith* [1987] 2 SCR 99 SCl No. 49 at paragraph 60

6 *RBC Dominion Securities Inc.* v. *Merrill Lynch Canada Inc.*, supra.. at paragraph 37

The Court reasoned that:

> "A departing employee has an obligation to refrain from soliciting the former employer's clients until the former employer has had a reasonable opportunity to contact the clients to reassure them that it is keen and able to continue to service their needs with qualified and capable staff. The length of time necessary will vary with the circumstances. Where, as here. the employee gives little or no notice of his or her departure, the period will usually be longer. Where, as here, the departure of numerous employees is coordinated and destined, though not deliberately designed, to lead to the collapse of the office they leave, the length of time will further increase to allow time for replacement employees to move in to cover the immediate crisis."?

The requirement to provide notice of departure is an overlooked aspect of the case. Where there is no agreement to the contrary with respect to non-competition or solicitation, and where the departing employees are not key employees, notice may become an employer's only tool to recover its losses. If reasonable notice is not provided and the employer suffers damage or irreparable harm, it will have a claim.

With respect to the branch manager, Mr. Delarnont, the Court determined that he carried a duty derived from the duty of good faith to perform the functions necessarily inherent to the role. The Court found that the manager's duty of good faith as branch manager required him to keep his regional manager fully and promptly advised of all significant information relating to the operation of the branch, particularly as to the events which had the obvious potential of damaging or destroying the viability of the branch. He was in serious breach of that duty, said the Court. The Court determined a serious fundamental breach of the duty of good faith on his part.

With respect to ML, it was held vicariously liable for the conversion of DS's records and for inducing DS employees' breach of the duty not to compete unfairly with DS.

The case is enlightening. It defines the continued high water mark in finding an employee to be a fiduciary. It is also useful for counsel when dealing specifically with common law breaches. The courts will assess in great detail the norms in a particular industry to determine whether the duty of loyalty has been breached by departing employees.

With the high bar set by the B.C. Courts, it is no surprise that our courts have also taken a very strict view of restrictive covenants contained in employment agreements.

Employees working from a home office or who are on the road may have exclusive contract with customers of an employer, even though they may not be key employees or senior management. How then is an employer to protect its interests?

Restrictive Covenants **in Employment** Agreements

It is accepted that all restrictive covenants are considered to be covenants in restraint in trade and are *prima facie* unenforceable. A covenant in restraint of trade will be enforceable only if it is reasonable as between the parties and due consideration having been given to the public interest."

The Supreme Court of Canada, in *LiC. v. J.* G. *Collins Insurance Agencies Limited.'* went one step further in establishing a three stage inquiry into assessing the reasonableness of a restrictive covenant.

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7 *Ibid.,* at paragraph 117
8 *Nordenfelt v. Maxim Nordenfelt Guns Ammunition Co.*. [1894] A.C. 535 (H.L.) page 565
9 *LC* v. *J.*G. *Collins Insurance Agencies Limited,* [1978] 2 S.C.R 916

The question before the Supreme Court of Canada was whether a restrictive covenant contained in a contract of employment was valid. In that case, an agreement was entered into for the purchase by the Collins company, of the general insurance business of a competitor, Elsley. A life insurance business and real estate business conducted by Elsley were not included. The agreement contained a covenant on the part of the vendor that it would not, for a period of ten years, carry on or be engaged in the business of a general insurance agency within the city of Niagara Falls and that the vendor would pay a penalty for each and every breach.

However, the parties entered into a further agreement whereby Elsley was employed as interim manager of the combined general insurance businesses, now owned by Collins, upon terms which included a restrictive covenant almost identical with that contained in the purchase agreement. That agreement was replaced with an agreement by which Elsley was to serve as manager of the Collins company's general insurance business in the greater Niagara Falls area. The agreement commenced June 1, 1956, and was stated to continue in force from year to year until terminated by either party upon three month's notice. It continued until May, 1973.

The management agreement contained a covenant that was quite general in nature. It was for a five year period after cessation of the employment. It was made subject to the covenant contained in the sale agreement for the purpose of assuring a minimum restrictive period of ten years and a maximum restrictive period of the term of employment plus five years.

Elsley had managed the combined general insurance businesses for seventeen years. He gave the required notice of termination of employment. During the seventeen year period, Elsley had dealt with the customers of the agency to the almost total exclusion of Collins. To them, Elsley was the business and Collins was little more than a name. Elsley met the customers, telephoned them frequently, placed their insurance policies, and answered their enquiries. People became accustomed to doing business with him on a personal basis and he looked after their insurance needs. He served not only customers of the business he formerly owned, but also Collins' customers.

Indeed, during his tenure many policy holders had paid their premiums at the office of Elsley's real estate office because a large part of the business purchased by Collins from Elsley came from the area in which the office was located. As general manager of the combined businesses, Elsley had access to all policy holder records. He was familiar with the nature and the extent of coverage and the premium paid by each policy holder. The Court determined that it was natural the policy holders would follow him if he made a move.

Following termination of his employment with Collins, Elsley commenced his own general insurance business. A large number of former clients of the agency transferred their business. This is what I determine to be the key to the *Elsley* case. One of the exhibits at trial was a list of approximately two hundred former clients who had advised Collins they were transferring their insurance business to Elsley. The only factual dispute in the entire case was whether Elsley solicited the business of former clients and he had denied doing so.

At trial, Elsley was ordered restrained until September 1, 1978, from carrying on the business of a general insurance agent within the defined area. He was also directed to assess the damages of Collins with respect to the business taken from him to the date of trial. The majority of the Court of Appeal affirmed the judgment at trial with one variation with respect to compensation.

The central issue before the Supreme Court of Canada was the restrictive covenant. It was contended that the restrictive covenant did not merely restrain the solicitation by Elsley of clients of Collins, it prevented Elsley from being engaged at all in the general insurance business in a large area and operated therefore to

eliminate competition *per se* without regard for the public interest and beyond necessary protection of Collins' interest.

The Court found, based exclusively on the employment contract (as the sale agreement had been exhausted temporally), that a covenant against solicitation alone would not have been adequate to protect the proprietary interest entitled to protection. The exhibit in evidence showing the actual damage supported that view. Notwithstanding that Elsley may not have solicited former clients, two hundred clients switched their custom to him. This in and of itself was an illustration of the influence of an employee over the customers of his employer. For those reasons, the Judge viewed the covenant as no wider than reasonably required in order to afford adequate protection to Collins.

The *Elsley* case is in my view, more akin to real life circumstances. Workers, whether senior or not, are interacting at least independently and sometimes exclusively with their employer's clients. As in the *Elsley* case, many of these employees are more than just the face of the business. They in fact *are* the business in a specific region and customers may follow them.

The key to the *Elsley* decision in my view, was the evidence at trial of the damage sustained by Collins, notwithstanding that the clients may not have been solicited.

The Supreme Court of Canada in the *Elsley* case also set the ground rules regarding the context of restrictive covenants. It found that there is a distinction made in cases between a restrictive covenant contained in an agreement for the sale of a business and one contained in a contract of employment. In a purchase and sale agreement, a vendor would be unlikely to sell his or her business without the right to assure the purchaser that he or she, the vendor, would not later enter into competition. Other than the standard difficulties in the definition of the time during which and the area within which the non-competition covenant is to operate, the court will normally give effect to such a covenant contained in a purchase and sale agreement.[10]

With respect to an employment or personal services contract, however, the courts are extremely unforgiving to the employer. The Supreme Court of Canada's view is that an imbalance of bargaining power in a contract of employment may lead to oppression and a denial of the right of the employee, to exploit, following termination of employment, his or her knowledge and skills obtained during employment. While there may be exceptions, blanket restraints on freedom to compete or any restraint which fails the court's test of reasonableness, will be held unenforceable.

It is my view that this approach does not take into account the actual agreement made between the parties when the employee joined the employer. In competitive industries, the hiring may be wholly contingent upon the employee's agreement not to compete for a period of time within geographic limits. Non-solicitation of clients is extremely important, but employers know all too well the damage that a non-key employee may do to their business after termination.

The interesting part of the analysis is that employees often execute these blanket restrictions after obtaining legal advice. They are sometimes advised by their counsel not to worry because the restriction will not hold up in court. Notwithstanding that employees are more sophisticated than ever before, often obtain legal advice and understand the restrictions, courts across the country remain steadfast in their views about restrictive covenants in employment agreements. Indeed, in the *Elsley* decision, the Court recognized that they are disinclined to restrict the right to contract, particularly when that right has been exercised by knowledgeable persons. Even so, the restrictions in a covenant of an employment agreement will not be enforced if overly broad or if a non-solicitation clause would suffice.

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[10] *Ibid.*, at page 7

In assessing the reasonableness of a restrictive covenant, the Supreme Court of Canada in *Elsley* restated the general and well known inquiry as follows:

> (a) Whether. in light of the nature of the business and the character of the employment, the employer had a proprietary interest entitled to protection;
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> (b) Whether the temporal or spatial features of the covenant are reasonable or are too broadly framed; and
>
> (c) Whether the covenant was against competition generally and accordingly against the public interest or was limited to the proprietary interest entitled to protection.[11]

Each of these factors merits consideration and discussion well beyond the scope of this paper.

Another often cited decision with respect to restrictive covenants in strict employment contracts is an Ontario Court of Appeal decision, *Lyons and Multari.*[12] In *Lyons,* the Ontario Court of Appeal reconfirmed that an employer has a difficult task ahead of it in enforcing a general non-competition clause in an employment agreement. As in cases before, the Court reiterated the general proposition that a non-solicitation clause will generally provide adequate protection for an employer, and only in exceptional cases will the nature of employment justify a non-competition clause.

Dr. Lyons, an experienced oral surgeon. hired Dr. Multari, a recent graduate, as a new associate for his specialized dental practice in Windsor, Ontario. Lyons' practice depended on referrals of patients from other dentists. The parties entered into an employment agreement that contained three provisions. Of note was the second provision which stated simply "Protective Covenant. 3 YRS.-5 MI."

Multari resigned from his employment seventeen months into it and less than a year after resigning, opened a competing oral surgery clinic less than five miles away from Lyons' office. At trial, Lyons sought damages for breach of the protective covenant clause and the trial judge held the clause reasonable and awarded Lyons damages.

The Court of Appeal confirmed that the protective covenant clause meant that MuItari was barred from opening another competing office within three years of termination anywhere within five miles of Lyons' office. The Court of Appeal quoted extensively from the *Elsley* decision and determined that Lyons succeeded on the first two points. Namely, Lyons had a proprietary interest worth of protection (his clients) and that the geographic and temporal limits were not overly broad. The case however rested on the third factor of whether the covenant restricted competition generally or merely barred the solicitation of the former employer's clients.

The Court of Appeal concluded that Multari did not playa special role that could have justified this broad restriction. The Court affirmed that a non-competition clause should be enforced where the nature of the employment will likely cause customers to perceive an individual employee as the personification of the company or employer. MuItari was a junior associate in practice in which Lyons was the dominant figure.

The Court of Appeal further noted there was no confidential information that required protection. While Multari did know the names of the dentists referring the clients he had treated, a simple non-solicitation clause would have sufficed.

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[11] *Ibid.*• at paragraph
[12] (2000) 50 O.R. (3d) 526 (ant. CA.).

In *Lyons,* the Court refused to find that the case before it was one of those exceptional cases where a non-competition clause was enforceable. It was determined that while Lyons had a proprietary interest in the dentists that did refer work to him, he did not have the same interest in dentists within the defined area who did not refer him business and who were subject as well to the covenant. The Court made clear that there is not proprietary interest in prospective clients.[13]

This high standard in employment contracts extends equally to independent contracts for services" and to partnership agreements.[14] In this context, a restrictive covenant barring competition by a former employee will not be upheld if a simple non-solicitation clause would suffice.

A recent Manitoba Court of Appeal decision is of assistance in determining what circumstances will generally be relevant for the court, in assessing whether a case is an "exceptional" one so that a general non-competition clause will be found to be reasonable. Oddly, when reviewing these factors based upon the Manitoba Court's summary of the jurisprudence, it remains a mystery why the court strikes down so many non-competition clauses in employment contracts. These are the nine factors:

1. The length of service with the employer;

2. The amount of personal service to clients;

3. Whether the employee dealt with clients exclusively or on a sustained or recurring basis;

4. Whether the knowledge about the client which the employee gained was of a confidential nature, or involved an intimate knowledge of the client's particular needs, preferences, or idiosyncrasies;

5. Whether the nature of the employees work meant that the employee had influence over clients in the sense that the clients relied upon the employees advice or trusted the employee;

6. If competition by the employee has already occurred, whether there is evidence that clients have switched their custom to him, especially without direct solicitation;

7. The nature of the business with respect to whether personal knowledge of the clients is confidential matter is required;

8. The nature of the business with respect to the strength of customer loyalty, how clients are won and kept; and

9. The community involved and whether there were clientele yet to be exploited by anyone."

With respect to a non-solicitation clause, the factors reiterated by the Supreme Court of Canada in *Elsley* will be considered.

All of these cases must be viewed in light of the well known common law rule which operates to release employees from restrictive covenants in the event of a breach of the employment contract by the employer, such as in the case of a wrongful dismissal.

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13 *Ibid.*. at paragraph 39
14 *Winnipeg Livestock Sales Ltd. V. Plewman,* [2000] M.1. No. 429, 2000 MBCA 60
15 *Scantron Corp. v. Brucke,* [1996] 0.1. No. 2138
16 *Winnipeg Livestock Sales Ltd. V. Plewman,* Supra., at paragraph 41

The cases provide us with valuable information about the necessary evidence required if your client is attempting to enforce a restrictive covenant against a former employee or if you are advising an employ about executing an agreement containing such a covenant. Broad non-compete covenants will still not be enforceable except in extremely rare circumstances. Reasonable non-solicitation clauses will be enforced and as lawyers, we need to focus on the language in these clauses to protect our clients' interests.

In my view, in reviewing the jurisprudence and in light of the modem trends in employment, the courts are overdue to apply the jurisprudence less conservatively. I believe it is only a matter of time before the courts recognize the vulnerability of some employers in the current market. This may not be true for every industry, but appears to me to be so in the high tech sector, insurance industry and other intensely competitive and sales or knowledge reliant industries. The message to employers is clear: The benefits of a well worded employment contract can be measured in dollars and cents.

Restrictive Covenants **in** Company Bylaws

Canadian courts have found the "exceptional" case when deciding the enforceability of a restrictive covenant contained in the bylaws of a corporation against an employee who is also a shareholder.

A series of recent decisions involving the employer Towers, Perrin, Forster & Crosby Inc. (''TPFC'') shed light upon the court's rational in distinguishing employment and personal service contracts from bylaws of a corporation in which an employee holds shares.

In a 1999 decision of the Ontario Superior Court of Justice on an injunction application, the Court considered the issuer" TPFC was an insurance provider of property and casualty insurance and was also in the financial services practice. The Employee, Cantin, was hired in 1986 by TPFC as an actuarial specialist. After a number of years, she became manager of the Toronto practice. A potential competitor to TPFC, KPMG, did not have such a practice in Toronto.

In 1999, Cantin announced her intention to resign and join KPMG to set up a Toronto office. She then did so.

At the time of her termination, Cantin was a shareholder of TPFC. The bylaws of the company contained two covenants, which TPFC claimed had been breached by Cantin upon her departure. TPFC also claimed against KPMG alleging unlawful interference with TPFC's economic interests.

In the *Cantin* decision, the Court reviewed the jurisprudence and came to the same conclusions as previous courts with respect to employment, service and partnership agreements. It then reviewed the unique facts before it to come to a different conclusion than its predecessors had.

The Court focussed on the fact that Cantin had the opportunity to purchase shares as a key employee. In consideration of holding the shares, TPFC required covenants, by setting out both a non-solicitation and non-competition clause in its bylaws.

The non-competition clause restricted the performance of services, the soliciting of business and the participation in client relationship management activities (of clients with whom the shareholder had performed services for or solicited business from or participated in client relationship management activities) during the two years preceding the date of cessation of employment. These bylaws had been provided to Cantin upon her purchase of the shares. As well, the restrictive covenants required a 2/3 majority to amend.

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[17] *Towers, Perrin, Forster & Crosby Inc. v. Cantin* (1999),46 O.R. (3d) 180; [1999] 0.1. No. 5735

The Court also considered that approximately thirty clients targeted by KPMG and Cantin were TPFC clients with whom Cantin had working relations prior to her departure.

The Court in *Cantin* did not dispute that on its face, the clauses were unenforceable as a restraint of trade. Even so, the Court found the clauses to be reasonable ones as between the parties. The Court liked TPFC's argument that Cantin, as a principal, was compensated by TPFC with special bonuses, increased prestige and stature as a principal. She received the increased value of the shares as the value of the firm rose. These were all benefits unavailable to non-principals. The evidence was that the value of Cantin's shares had increased during her tenure, but the Court was not overly interested in that. Rather, it focussed upon the offer and acceptance of becoming a principal and the consideration provided by TPFC:

> accept that Cantin wanted to become a principal in Towers Perrin and that she understood that if she did, she would be expected to purchase shares and therefore be subject to the covenant in the by-law against competition. Once she became a principal, there was a certain obligation to acquire the shares when they were offered. But Cantin was not compelled to become a principal. Sherma asserted that Cantin had freely chosen to become a principal with all of the benefits and obligations which that entailed, including the obligation not to compete.
>
> I find that Cantin voluntarily accepted both the privileges and the obligations entailed in becoming a shareholder which distinguishes this case from most others. In the employee cases. the court readily assumed that there was an imbalance of bargaining power. ..That is not a consideration here ...Her status as a shareholder was a benefit of her promotion as principal. She chose to acquire shares. In this situation, I find that there is no imbalance of bargaining power.,dS

The Court also reasoned, based upon the nature of actuarial work, that the two year stipulation was applicable. Indeed, the Court focused as well on the nature ofTPFC's clients' businesses. The general ability of Cantin to earn a livelihood by not competing had not been made an issue. On the whole, the Court reasoned that this fit within the "exceptional case" rule.

In a subsequent 2003 Quebec Superior Court decision involving TPFC and another employee shareholder, the Court was faced with similar facts to the *Cantin* case. While there were some oddities as a result of Quebec law, the Court determined that a verbal employment contract between TPFC and the employee and the non-competition clause contained in the bylaws were intimately linked to the point that one cannot exist without the other. The share ownership program reasoned the Court, was an integral part of the employee's employment contract even though it was contained within the bylaws."

These cases illustrate an interesting turning point for Canadian courts. Judges are more ready to uphold non-competition clauses if some sort of consideration is provided to a senior employee, over and above the terms of their employment in return for the a non-competition clause.

Canadian courts have also enforced stock option plans and retiring allowance plans whereby the employee is entitled to the consideration only if he or she chooses not to compete with the employer for the duration of the benefit period or a defined period."

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[18] *Ibid.,* at paragraphs 59 and 60

[19] *Towers Perrin Forster* c. *Girardin,* [2003J Q.l. No. 16092; [2005J RD.Q. No. 851 (Quebec Superior Court)

[20] *Nortel Networks Corp.* v. *Jervis,* [2002J 0.1. No. 12 (Ontario Superior Court) and *Henriksen v. Tree Island Steel Co.,* [1983J B.Cl. NO. 1777; (1983), 45 B.CL.R 114 (B.CS.C)

Practical Solutions to Ensure Enforceability of Restrictive Covenants

a) Employment Contracts

Employers need to be proactive in protecting their proprietary information. The start of course, is in the drafting of employment contracts.

As employer counsel, we need to ensure that our clients are not using antiquated contracts containing just the sort of broad non-competition language that has been so badly battered by our courts. The key is in the planning. Lawyers need to carefully take an overview of their client's business and determine what the client needs to protect. Lawyers need to understand the norms in the client's particular industry or sector to establish whether patterns exist. They need to understand the client base and their respective norms and patterns. Lawyers need to review the specific employment arrangement and the duties of the employee. It is only after a full understanding of this information that employer counsel will be prepared to determine an action plan for the employment agreement to help ensure that it will be upheld by our courts if tested.

Lawyers need to reassess the common law requirement for notice of termination. This is part of an arsenal of protection for the employer that is rarely used.

As employee counsel, it is no longer adequate to say "sign it because it won't hold up in court anyhow." The approach is not, in my view, of assistance to an employee who is faced with an injunction application down the road. Rather, it would be beneficial for both employer and employee to understand and agree up front to their rights and obligations upon departure from employment. It may be an opportunity for the employee to negotiate additional consideration in exchange for a promise not to compete, where such restriction would otherwise be invalid.

b) Incentives

The idea of providing supplemental consideration to a senior employee in exchange for his or her loyalty and promise not to compete, is not uncommon and is a good practical tool.

As Dean A. Crawford noted in a recently published article in *the Advocate,* the British practice is to use an incentive for employees not to compete, referred to as "garden leave". Employment contract for senior staff may contain notice provisions, whereby both the employer and the employee agree to provide defined notice upon termination of employment. The employer cannot require the employee to come to work during this period, but continues payment of salary and benefits. In return, the employee cannot work for a competitor, since to do so would be a breach of his or her continuing obligations as an employee. The period of notice provides enough time for the employer to strategize around the departure of the employee."

Any additional consideration in exchange for an agreement not to compete will provide the employer with the necessary time to secure its client base and will likely be upheld by our courts. In my view, consideration in exchange for a strict restrictive covenant will increasingly be viewed as a fair bargain.

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[21] *Protecting Employers From The Departing Emplovee: Alternatives To the Use OfRestrictive Covenants,* By Dean A. Crawford, published in he Advocate", Vol. 64, Part I, January 2006