Employment Law

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Restrictive Covenants in Employment

"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."
Nordenfelt v. Maxim Nordenfelt, [1894] A.C. 535 (H.L.) at p. 565

Introduction

Most employment rights and obligations apply during the period of employment, but a few survive the end of employment. Employees who are considering quitting or who might be dismissed should be aware of any post-employment obligations binding upon them.

Many people work for years in the same career or industry. If they leave, they might take too much of their training and inside knowledge and experience of the current employer's business straight into a competitor's workplace. Or they may unfairly set up their own business and compete nearby with the former employer. If an employee wants to quit and start a competing business or merely work for a competitor, it does not seem right that he or she should be able to collect papers, customer lists, secret formulas, business processes, and contact customers to encourage them to move to the new business. This is tempting and easy to do especially if quietly carried out over months prior to departure. It could unfairly and seriously injure the current employer's competitive position. The written employment contract for certain key workers, therefore, may contain a restrictive covenant, also referred to as a non-competition agreement, in which the employee has agreed not to work in the same industry within a specified territory for a period of time after leaving. Entirely for the benefit of the employer who has trusted and invested in that employee, it seeks to prevent unfair competition by former employees.

Balancing Employer and Employee Interests

The law recognizes that while there is a valuable public policy in the free movement of labour and a competitive marketplace, there is also a private ownership interest of the current employer that deserves legal protection as a result of the trust employers place in employees. The law seeks to strike a balance between these public and private interests. A restrictive covenant offends public policy as a restraint of trade and therefore will be *prima facie* void from the beginning unless a court concludes that it is reasonable as between the parties.

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Legal Tests for Enforceability

All three of the restrictions found in most non-competition agreements must be reasonable as balanced between the needs of the employer to protect its business interests and the departing employee. If the covenant's enforceability is challenged in court, the onus will be on the former employer to show that it is reasonable in all three respects.

1. Prohibited Activity

All departing employees must still be permitted to earn a living. The employer can only restrict the employee from working in a field that competes with the employer's business. A departing manager of a coffee shop could, for example, be prohibited from working in all other coffee shops but not from selling electronics or teaching high school.

2. Prohibited Territory

The non-competition agreement should go no further than to exclude the employee from the geographic territory in which the employer actually draws business. If an employer hairdresser draws her business from a few square kilometers around her shop, it would be unreasonable to prevent a departing employee from working as a hairdresser across the city. That would be a far broader territorial exclusion than is necessary.

3. Time Period

The restrictive covenant may only operate for a short time. An employer cannot keep an employee out of the industry and out of competition indefinitely. Three years is generally considered the longest reasonable period of exclusion today in Canada. Stipulating a period much longer than that without sufficient corresponding economic rationale on the part of the employer runs the risk of the restrictive covenant being found unreasonable and therefore unenforceable.

Not all industries travel at the same speed. Two years in retail is not the same thing as two years in fast-paced technology where competition changes quickly. To exclude a software developer or a professional athlete from the market for two years is more serious than excluding a taxi driver for the same time period.

Other Reasonableness Factors

Every case is different and will be considered on its own facts. If the employee was terminated without cause, such as a layoff due to lack of work, had only worked for a short time, or only part-time, it may be unreasonable to impose a restrictive covenant. The employer relying upon the covenant should be able to demonstrate likelihood that the business would be unfairly impacted by the departing employee in the absence of the covenant.

Clarity in Restriction Language

The restrictive covenant must be clear in its restrictions. Given the public policy concern, the courts do not start out favourably disposed to these clauses, and if they are ambiguous, the courts may be inclined to rule them unenforceable. One common

example is the use of the word "radius" in the context that the employee is not to work within the radius of X kilometres. A radius requires an identifiable point from which to "radiate" the territory. This might be a local landmark or the front door of the employer. The corporate limits of a large municipality are not a finite point from which to draw a radius.

In the 2009 *Shafron* case, the Supreme Court of Canada considered a clause that stated that an employee could not work in the insurance brokerage business within the "Metropolitan City of Vancouver" for three years. He worked for some twelve years with the buyer of his business, but then quit and went to work as an insurance salesman for another agency in Richmond, B.C. The issue was whether Richmond was within the "Metropolitan City of Vancouver" which itself has no legal meaning and is ambiguous.

The reasonableness of activity, time, or geographic restrictions cannot be determined if they are ambiguous. An ambiguous restrictive covenant is, on its face, unreasonable and unenforceable. The question was then whether the Court could interpret it in such as way to render it reasonable. The Supreme Court of Canada said that "notional severance," reading down a clause to make it legal and enforceable, is inappropriate to cure an ambiguous restrictive covenant. Courts will not simply rewrite a covenant to what it subjectively considers reasonable, or employers would draft overly broad restrictive covenants and invite the court to sever any unreasonable parts or read down the covenant to what is reasonable. The Supreme Court said this would alter the risks assumed by the parties and increase the chances that employees will face unreasonable restrictions.

The Court also considered "blue-pencil severance" which involves deleting part of the clause. The expression came from a 1920 English case which said, "the part severed can be removed by running a blue pencil through it." In *Shafron*, could the word "Metropolitan" be simply deleted? The Court said that "Metropolitan," while technically meaningless here, was a part of the bargain the parties struck going to the essence of this restriction, and it could not be removed in this way. Nor could the doctrine of rectification be invoked to rewrite the bargain between the parties. In the result, the whole restrictive covenant was struck out as unenforceable because of the ambiguity created by the generic word "Metropolitan."

Alternatives to the Restrictive Covenant

The employer relying on the restrictive covenant has the burden of showing that it is reasonable in all respects before being entitled to enforce it and preventing competition from the employee. In some scenarios, the main competitive concern might be only about the disclosure of confidential information to third parties. A more limited and specific non-confidentiality clause will suffice. In other scenarios, the main competitive concern might be only about contacting current employees or customers. In such a case, a non-solicitation clause will adequately address that concern. It prohibits the employee from soliciting, or marketing to, the current customers of the employer but allows the employee freedom to compete in that industry.

Since these two alternatives carry fewer restrictions, and are less coercive and less troubling from an anti-competitive public policy perspective, they are more likely to pass the test of reasonableness and obtain judicial approval. Some courts ask if one of these two alternatives would adequately protect the employer. If so, a more onerous restrictive covenant will be found to be unreasonable.

Drafting Practicalities

In addition to the advice to write the restrictive covenant with meticulous clarity, the employer might want to include a remedies section, including liquidated damages and solicitor and client costs, and stipulate that the restrictions continue even where the employee incorporates or otherwise holds shares in a business, consults with, or lends his or her name to a competitor.

The clause should not only apply where the employee voluntarily quits but also where he is terminated with cause, because employees can intentionally precipitate their termination and should not be exempt from the restrictive covenant for doing so.

The covenant should be in writing and explicitly addressed at the time the employee starts work. If it is added after the original employment start date, it must be carefully incorporated into the legal relationship according to the doctrines of consideration or notice. It is also wise to explain these post-employment contractual obligations at the time the employment ends.

Legal Remedies

Former employers, faced with breaches of restrictive covenants, usually apply for an injunction to enforce the post-termination obligations, and they may further sue for breach of trust, fiduciary duty, or confidentiality in order to claim compensatory damages. Employees found in breach of reasonable restrictive covenants may be required to account for and pay profits earned as a result of the breach to the former employer.

Conclusion

A restrictive covenant is a common mechanism for employers to preserve their business interests from the risk of departing employees who seek to unfairly compete in that business in the same market. If challenged, the terms of the covenant will be scrutinized for reasonableness. The court will consider what is the least restriction necessary to protect the legitimate business interests of the former employer and balance that with the hardship the restriction presents to the employee. The covenant needs to be carefully drafted and brought to the attention of the employee when the obligation is created.

The best protection for the employer, as for all employment risk-reduction strategies, is to choose employees prudently and to treat them well.

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