Crafting and Enforcing Restrictive Covenants in Canada

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The purpose of this publication is to provide information as to developments in the law. It does not contain a full analysis of the law nor does it constitute an opinion of Norton Rose OR LLP on the points of law discussed.
A. Introduction

In the modern knowledge-based economy, information and know-how are among an organization’s most significant assets, and its employees are important repositories of those assets. The employer can be vulnerable when key employees leave the organization. Its former employees may wish to work for its competitors, solicit its clients or its present employees, or disclose its confidential information in a manner that will be harmful to the organization’s business. To avoid these results, employers often insert restrictive covenants into their contracts of employment to restrain employees’ activities upon departure. However, restrictive covenants raise further issues. When ought a court to allow the organization to rely on them, given the former employee’s interest in making a living by applying his or her knowledge and experience? Do restrictive covenants interfere with the public interest in free competition in the marketplace? If a covenant should be enforced, how can the organization do it?

This paper discusses the approach that Canadian courts have taken to these increasingly important questions. It focuses on the province of Ontario, which is representative of the common law jurisdictions of Canada. Quebec, which is governed by a civil law system, will also be briefly discussed. As will be seen, Canadian courts outside Quebec take the view that restrictive covenants are presumed to be illegal restraints on trade. However, covenants will be enforced where they protect a legitimate proprietary interest of the employer, where they are reasonable with respect to duration, geographic scope and subject matter, and where they are actually necessary to protect the employer’s interests.

B. Ontario and Other Common Law Provinces

i. General

Before discussing specific types of restrictive covenants, it is helpful to describe the general principles that are applied to their enforcement. In its 1978 decision in Elsley v. J.G. Collins Insurance Agencies Limited,1 the Supreme Court of Canada set down a number of principles that continue to govern courts’ approach to restrictive covenants today. These principles recognize, on the one hand, the importance of free market competition and avoiding restraints on trade. On the other hand, the Court stressed the

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principle that contracts should be respected, particularly when they are entered into by parties with roughly equal bargaining power. To balance these competing principles, the Court decided that while restrictive covenants would be presumed to be illegal restraints on trade, a covenant could nonetheless be enforced as long as the party relying on it established that its terms were "reasonable" in all of the circumstances.

When determining the "reasonableness" of a restrictive covenant, the Supreme Court continued, courts should consider the following three questions:

1. Did the employer have a proprietary interest entitled to protection?

2. Are the temporal or spatial features of the covenant too broad?

3. Is the covenant contrary to the public interest for restricting competition generally?

Since *Elsley* was decided, courts have had ample opportunity to expand on and clarify these considerations. With respect to the first question, it is clear that confidential information, trade secrets, business connections with customers and goodwill are all proprietary interests which a restrictive covenant can legitimately protect. An employer may also have proprietary interests in certain business relationships, such as, in one leading case, an oral surgeon’s relationships with dentists who refer him work.²

The second and third *Elsley* questions are meant to ensure that the covenant is no broader than necessary to protect the employer's legitimate business interests. Courts have found that employers must restrict both the duration and the geographic scope of the covenant. A reasonable duration takes into account the time required by the employer to replace the departing employee, to train the replacement, and to allow the replacement to solidify his or her customer relationships. A reasonable geographic scope is one that is limited, precise, and no larger than necessary. In some circumstances, courts have also found that the subject matter of the covenant must be restricted. For example, if an employer’s legitimate needs will be protected by prohibiting the solicitation of its current clients, the covenant will not also be allowed to prohibit solicitation of prospective clients.

A final general principle that employers should keep in mind when drafting restrictive covenants is that any ambiguity is likely to render a covenant unenforceable. In its 2009 decision in *Shafron*, the Supreme Court of Canada emphasized that it is the employer who bears the burden of drafting a clear and unambiguous restrictive covenant:

However, for a determination of reasonableness to be made, the terms of the restrictive covenant must be unambiguous. The reasonableness of a covenant cannot be determined without first establishing the meaning of the covenant. The onus is on the party seeking to enforce the restrictive covenant to show the reasonableness of its terms. An ambiguous restrictive covenant will be prima facie unenforceable because the party seeking enforcement will be unable to demonstrate reasonableness in the face of an ambiguity.\(^3\)

In *Shafron*, the covenant at issue restricted activities of former employees in the “Metropolitan City of Vancouver,” an entity that does not legally exist. It was not clear which of Vancouver’s surrounding suburbs were intended to be included, if any. Consequently, the covenant was deemed ambiguous as to its geographic scope, and was therefore unenforceable.

**ii. Non-Solicitation Covenants**

A non-solicitation covenant restricts an employee from soliciting clients of his or her former employer. It is designed to protect the employer’s interest in preserving its existing client base. This can be a real concern for employers if the departing employee is an important client contact person, since clients may be quite willing to follow the employee to a competitor.

Ontario courts have recognized that the employer’s interest in its client base is a proprietary interest entitled to protection.\(^4\) Courts also generally recognize that a non-solicitation clause does not prohibit competition generally; it allows the former employee to compete with the employer, and it even allows former clients to switch to the competition, as long as they come unsolicited.

Disputes over non-solicitation covenants, therefore, generally turn on the second *Elsley* question, whether the features of the covenant are overly broad. A covenant with a duration of one to two years will generally be upheld,\(^5\) while the appropriate geographic restriction varies from case to case. However, employers must consider subject matter restrictions in addition to duration and geographic ones. In *Brown*, for instance, where the employee was prohibited from soliciting anybody who had ever been a client of the employer, the covenant was struck down for overbreadth. There was no legitimate business reason to restrict the employee from soliciting clients who had not engaged the employer in many years, and whom the employee himself may never have served during his employment.\(^6\)

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3 *Shafron v. KRG Insurance Brokers (Western) Inc.*, 2009 SCC 6 at para. 27.


iii. No-Hire Covenants

A no-hire covenant is similar to a non-solicitation covenant, except that instead of prohibiting the solicitation of clients, it prohibits the solicitation of other employees. In some cases it may go even farther, and prohibit hiring any person who works for the employer, even if the person’s job application was unsolicited.

The employer’s interest in no-hire clauses is obvious. Experienced, trained and knowledgeable employees are extremely important assets that employers will want to retain. Moreover, employees will often possess detailed know-how relating to the employer’s processes and operations that it will want to keep out of competitors’ hands.

Courts apply similar analyses to no-hire clauses as to non-solicitation clauses. The preservation of an employer’s workforce is generally acknowledged to be a proprietary interest worthy of protection. The key question is whether the covenant’s terms are broader than necessary to protect the employer’s legitimate business needs. As with non-solicitation clauses, the court will consider not only temporal and geographic breadth, but also the breadth of the subject matter covered by the covenant.

Earlier this year, the Ontario Superior Court of Justice considered all three areas of overbreadth in Dent Wizard (Canada) Ltd. v. Catastrophe Solutions International Inc. The employee, a former manager of the plaintiff company, had entered into a Termination Agreement which lasted four years and provided for a graduated retirement. He would remain an employee without day-to-day responsibilities for two years, would be exclusively available to the company as a contractor for a further two years, and his restrictive covenants would last another two years after that.

The court found that his no-hire clause, as well as other restrictive covenants, were overly broad in duration. Six years was far longer than necessary to protect the company’s legitimate interests. There were no geographic restrictions whatsoever. Finally, the subject matter of the covenant prohibited the employee from soliciting employees for any “automotive reconditioning business.” This term was broad enough to comprise types of business which the employer had never even performed. Since the clause was overly broad, it was rejected as an unreasonable restraint on trade.

The British Columbia Supreme Court reached a similar conclusion in F & G Delivery Ltd. v. MacKenzie, finding that a no-hire clause was overly broad in its subject matter. The clause did not restrict itself to

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7 2011 ONSC 1456.
8 Dent Wizard at paras. 68-70.
9 2010 BCSC 195.
protecting the company's current employees, but also extended to its former employees. The employer had no legitimate proprietary interest in its former employees, so this clause was broader than necessary.

The lesson for employers to learn from these cases is not to overreach. Non-solicitation clauses, whether for clients or for employees, will often be upheld in Canada, but only if they are strictly limited so that they prohibit no more employee activity than is necessary for the employer's legitimate business interests.

**iv. Non-Competition Covenants**

Non-competition covenants go substantially farther than non-solicitation and no-hire covenants. While the covenants discussed above prevent an employee from "poaching" customers or workers from the employer, non-competition covenants restrict the employee from competing altogether, which can create difficulties if his or her experience and ability to earn a living are bound up in a particular industry. Furthermore, as articulated by the Supreme Court of Canada in *Elsley*, there is a public interest in preserving free markets, and employers should not generally be allowed to restrict their own competition. Accordingly, in the context of a contract of employment, Canadian courts will enforce a non-competition covenant only in rare circumstances in which a non-solicitation covenant is insufficient to protect the employer's legitimate interests.

*Lyons v. Multari, supra*, a 2000 decision of the Ontario Court of Appeal, is a leading case on non-competition clauses. Dr. Multari, who had recently completed his oral surgery specialization, moved to Windsor, Ontario and joined forces with Dr. Lyons, a well-established surgeon looking for a new associate. They agreed to a remarkably concise non-competition covenant; it read, in its entirety, "Protective covenant. Three yrs. – 5 mi." 17 months later, Dr. Multari resigned, but before three years were up, he opened a dental practice that was only 3.6 miles from that of Dr. Lyons.

The Court accepted that Dr. Lyons had a legitimate proprietary interest in his sources of referrals, and also accepted that in the circumstances, three years and five miles were reasonable temporal and geographic restrictions. The stumbling block for Dr. Lyons was the third question expressed in *Elsley*, whether the covenant was against the public interest for restraining competition generally. The Court held that there were no exceptional circumstances in this case that would prevent a simple non-solicitation clause from protecting Dr. Lyons' interests. Since the covenant restrained competition unnecessarily, it was unreasonable and unenforceable.

*Elsley* provides a good counterexample in which "exceptional circumstances" did exist which were found to justify a non-competition covenant. Elsley sold his general insurance business to his competitor, J.G. Collins. Following the sale, Elsley was employed by J.G. Collins as a manager; in total, he managed the business for 17 years and was the predominant contact person for customers. As far as the customers were concerned, the Court found, Elsley was the business. In these circumstances, should Elsley
compete with J.G. Collins, he would likely appropriate J.G. Collins’ business relationships and customers, even if they were never solicited. A non-solicitation clause was inadequate to protect the employer’s interests, so the non-competition covenant was reasonable.

The circumstances of Lyons v. Multari, though, are far more commonplace than the circumstances of Eisley. As the Ontario Court of Appeal noted in the subsequent decision of H.L. Staebler Co. v. Allan, in a “conventional” employer/employee relationship, a non-solicitation covenant will be sufficient to protect the employer’s needs, and a non-competition covenant will not be enforced.\(^\text{10}\)

Non-competition covenants, however, are more likely to be enforced if they are not part of the contract of employment, but are instead entered into at the end of employment as part of a termination agreement. The reason is that the employee is likely to have greater bargaining power at this point and will be freer to choose whether or not to accept any particular severance package. If the employee does accept a package which goes above and beyond the termination or severance pay to which he or she would otherwise have been entitled, the employee will have knowingly and deliberately executed the restrictive covenant in exchange for valuable consideration. In these circumstances, courts will be more likely to hold the employee to his or her bargain.

Although the restrictive covenants in Dent Wizard, supra were not ultimately enforced, the Court’s reasoning in that recent decision is illustrative of courts’ attitudes. The Court emphasized the sophistication of the employee and concluded that the termination agreement had been entered into in an informed and voluntary manner. The restrictive covenants contained in the termination agreement were to last six years after the employee’s effective termination, but for the first two of those years, the employee was to remain on payroll, and for the second two years, he was to receive a retiring allowance and ongoing medical benefits. The Court suggested that had the restrictive covenants been limited to the four-year period in respect of which the employee received this consideration, rather than extending two additional years, they likely would have been found to be reasonable:

While I am sympathetic to the applicants’ submission that during the first four of those six years DWC paid real money to Pietrantonio in consideration for the restrictive covenants it received from him, the difficulty with Section 12 is that it rolls together into one bundle the restrictions both for the periods during which consideration was paid and the period when it would not be paid.\(^\text{11}\)

\(^{10}\) 2008 ONCA 576 at para. 55.

\(^{11}\) Dent Wizard at para. 66. See also para. 72 where the Court repeats that this was not a case of an employer taking advantage of a vulnerable employee, notes “that courts generally look askance at parties who seek to escape the burden of contracts into which they have freely entered,” and strongly implies that covenants with shorter duration would have been enforceable.
v. Non-Disclosure Covenants

Unlike non-solicitation, no-hire and non-competition covenants, which are presumed to restrain trade and are looked on with suspicion, confidentiality is considered a general duty of employment which exists even in the absence of a written agreement. Accordingly, employers seeking to enforce a non-disclosure or confidentiality covenant do not normally need to overcome a presumption of illegality by establishing its reasonableness. However, courts may nonetheless consider the reasonableness of a confidentiality covenant, and if it is clearly unreasonable or overbroad, it may not be enforced.

The larger hurdles faced by Canadian employers in enforcing non-disclosure covenants are evidentiary. Canadian law does not recognize the American doctrine of inevitable disclosure, which allows a court to find a breach of a non-confidentiality agreement, in certain circumstances, where the employer can prove that the employee will not be able to help but disclose confidential information upon moving to a competitor. The fact that an employee takes a position with a competitor is not alone sufficient to establish that he or she will inevitably disclose confidential information under American law, but the employer can establish “inevitable” disclosure by, for example, demonstrating the extent of the employee’s specialized knowledge of confidential information, and that the nature of his or her new position will require the employee to make decisions based on that information.\(^\text{12}\)

However, in Canada, the British Columbia Supreme Court has held that “[t]he application of this [inevitable disclosure] doctrine . . . in my view, would require a significant change in the tests applicable in this country.”\(^\text{13}\) Similarly, in Longyear, the Ontario Superior Court of Justice held, “I am also not satisfied that the doctrine of ‘inevitable disclosure’ put forth by [the employer] based on U.S. authorities is the applicable law in Canada.”\(^\text{14}\)

The courts’ rejection of inevitable disclosure means that it is not sufficient to prove that the employee will likely need to disclose confidential information based on the nature of his or her new position. An employer seeking to enforce a confidentiality agreement must bring evidence capable of proving, on a balance of probabilities, that confidential information is actually being disclosed.

This leads employers to a second hurdle, which is to establish that the information they seek to protect is actually confidential. As Future Shop explains, any information which is trivial in nature or accessible from public sources will not be considered confidential. For example, this principle has led courts to conclude

\(^{12}\) See PepsiCo, Inc. v. Redmond, 54 F.3d 1262, often considered the leading case on inevitable disclosure.


that pricing information is not confidential. In *Packall Packaging Inc. v. Chantiam*, the Court found that since customers in the relevant industry would price shop, and in doing so would often reveal to one company the prices quoted by its competitors in order to encourage the company to match or beat the other's price, pricing information was sufficiently publicly available that it was not confidential.

As well, aside from specific trade secrets, any information that remains in the employee's memory forms part of his or her knowledge and skill set, which the employee can freely use in the service of another employer. Furthermore, for information to be confidential, it must relate to the employer's business. Thus, when an employer withdraws from a certain line of business, information relating to that aspect of its business will no longer be confidential.

An important step that a Canadian employer can take to avoid confusion (and possibly some litigation) is to include an express definition of "confidential information" in its confidentiality covenants. However, as with other restrictive covenants, the employer should restrict the definition to cover only the types of information that must actually be protected in order to preserve the employer's legitimate interests.

**vi. Canadian Courts Rarely Amend Restrictive Covenants**

In addition to their differences with respect to the inevitable disclosure doctrine, American and Canadian courts differ drastically in their willingness to amend an unreasonable restrictive covenant to make it reasonable. In its *Shafron* decision in 2009, the Supreme Court of Canada addressed two amendment techniques, "blue-pencilling" and notional severance. Blue-pencilling refers to crossing out (severing) words or phrases that make the clause overly broad. For example, if a covenant unreasonably prohibits the solicitation of "current or former employees," blue-pencilling might remove the words "or former." Notional severance, meanwhile, reads down the words of the covenant without removing them. An example is converting a six-year restriction on solicitation into a more reasonable two-year restriction.

The Supreme Court ruled in *Shafron* that blue-pencilling should only be used "sparingly," and only where the part of the covenant being severed is "clearly severable, trivial and not part of the main purport of the restrictive covenant." Notional severance, meanwhile, can never be applied to a restrictive covenant. The Court's extreme reluctance to amend restrictive covenants means that employers must be careful to

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16 *Future Shop* at para. 57.
18 *Shafron* at para. 36.
19 *Shafron* at paras. 37-42.
make their covenants reasonable in the first instance. An employer who overreaches will likely end up not with a narrowed covenant, but with no covenant at all.

vii. Enforcing Restrictive Covenants

Assuming that a restrictive covenant is enforceable, how can the employer enforce it? An employer will typically seek both damages and injunctive relief. The difficulty with the latter is that by the time a court can render a decision, much of the potential damage to the employer has already been done. Therefore, the employer should also bring a motion for an interim injunction, restraining the employee from violating the covenant until a final decision is rendered.

The test for granting an interim injunction is a difficult one for employers to meet. The employer must prove the following three elements:

- There is a strong *prima facie* case for the violation of an enforceable covenant;
- There will be irreparable harm to the employer if the injunction is not granted; and
- The balance of convenience favours granting the injunction.

In respect of the first element, which relates to the strength of the plaintiff's case, the employer faces a higher burden in a restrictive covenant suit than in most interim injunction requests. The employer is required to prove a “strong *prima facie* case,” while most plaintiffs need only establish a “serious issue to be tried.” The more difficult test is imposed because an interim injunction decision enforcing a restrictive covenant is likely, in effect, to be a final decision. By the time the matter reaches trial, the covenant will have expired or the damage will have already been done, rendering a permanent injunction moot.\(^\text{20}\)

Furthermore, with respect to “irreparable harm,” the employer must establish harm that cannot be compensated by an award of damages after a trial. A simple loss of contracts with certain customers would likely not be sufficient to establish irreparable harm, because the values of those contracts could be easily calculated and awarded. However, if the employer stands to suffer a loss of goodwill, a severance of customer relationships, or a serious business decline, these types of harms might ground a case for an interim injunction.

C. Quebec

Quebec law on employment, contracts and covenants differs from that in the rest of Canada because Quebec maintains a civil law system for matters that fall within provincial jurisdiction. With respect to

\(^\text{20}\) *Brown v. First Contact Software Consultants Inc.*, *supra*.
restrictive covenants, an important theoretical difference between Quebec and the common law provinces is that such covenants are not presumed to be invalid in Quebec as a restraint of trade. However, despite this theoretical distinction, in practice, similar principles apply to the enforcement of restrictive covenants in Quebec as in the other provinces.

Section 2089 of the *Civil Code of Quebec* expressly provides that non-competition clauses may be included in a contract of employment. However, that section adds that "[s]uch a stipulation shall be limited, however, as to time, place and type of employment, to whatever is necessary for the protection of the legitimate interests of the employer." Although the *Civil Code* does not expressly address non-solicitation or no-hire clauses, the courts treat them like non-competition clauses, and they must be similarly restricted.

As in Ontario, the employer in Quebec bears the burden of proving that a non-competition agreement or other restrictive covenant is no broader than necessary to protect the employer’s interests. As well, Quebec courts are just as reluctant to sever or read down overly broad covenants so as to make them enforceable. Employers must be careful when first drafting their covenants that they do not overreach, or they risk having the covenants struck down entirely.

Furthermore, the *Civil Code* provides that an employer may not avail itself of a restrictive covenant in an employment contract if the employer has unilaterally terminated such a contract without a serious reason, or if it has given the employee a serious reason for terminating the contract.

For a time, Quebec courts had been more willing than their common-law counterparts to apply the doctrine of inevitable disclosure when assessing whether an interlocutory injunction was appropriate.21 Recent decisions, though, seem to have definitively closed the door to the applicability of such doctrine in Quebec, as elsewhere in Canada.22

**D. Conclusion**

Canadian courts presume most restrictive covenants in employment contracts to be unenforceable as contrary to the public interest, unless the party seeking to rely on them can establish their reasonableness. Non-solicitation, no-hire and non-disclosure covenants will often be accepted as reasonable, so long as they are appropriately limited in duration, geographic scope, and subject matter. The employer should strive to restrict no more of the employee’s behaviour than is actually necessary to

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protect the employer’s legitimate business interests. If the covenant is overly broad, it will likely be unenforceable, and a court will not be willing to sever it or read it down so as to make it enforceable.

Non-competition covenants, on the other hand, are rarely enforceable in Canada. Again, a court will not allow the employer to proscribe more behaviour than is necessary to protect its interests, so it will not enforce a non-competition covenant where a simple non-solicitation clause will protect the employer just as well. It is advisable for employers to make separate covenants for non-competition and non-solicitation, so that if the former is struck down, the latter may still be enforced.