PALLETT VALO LLP
Lawyers & Trade-Mark Agents

Your Authority For:
Business Law • Commercial Litigation • Commercial Real Estate
Construction • Insolvency & Corporate Restructuring
Labour & Employment • Wills, Estates & Trusts

w w w . p a l l e t t v a l o . c o m

Business Law / Commercial Litigation
June 2013

Less is More When Drafting Non-competition Clauses, Even When Selling Your Business

Many successful businesses start small – often through the efforts and skills of a few key individuals working together. When the time comes to incorporate, these key players often include non-competition and other similar clauses in their shareholders' agreement. Recent case law indicates, however, that even when sophisticated business people agree to be bound by these types of clauses, a court can still refuse to enforce them.

Non-competition and non-solicitation clauses in shareholders' agreements are usually triggered if one or more of the shareholders later decide to sell their shares and pull out of the business. Their purpose is to restrict the ability of the departing shareholders to set up a competing business and solicit the corporation's clients. Similar clauses are often used in employment agreements to prevent a key employee from competing with the employer's business after leaving the company.

Courts are not generally fond of non-solicitation and non-competition clauses found in employment agreements because they interfere with the departing employee's individual liberties and because of the unequal bargaining power between employers and employees. A court may refuse to enforce such clauses if they too broadly restrict the departing employee from earning a living.

In the business context, these types of clauses are more often upheld, as the law recognizes that they are needed to protect the goodwill in the business which the purchaser of the shares has paid for. Shareholders are also more likely to have equal bargaining power when negotiating with each other and will often have their own legal advisors look over the shareholders' agreement, including the non-competition and non-solicitation clauses, to make sure they are reasonable.

However, as demonstrated by a recent Ontario Court of Appeal decision, *Martin v. ConCreate USL Limited Partnership*, 2013 ONCA 72, parties to a commercial transaction seeking to rely on a non-competition clause that too widely restricts the departing shareholder's business activities may also find themselves subject to close scrutiny by the Court. In that case, the Court refused to enforce a non-competition and non-solicitation clause against a former shareholder on the sale of a business, finding that the duration of the covenants was unreasonable.

Background

The appellant, Derek Martin ("Martin"), a 38 year old "accomplished and successful businessman" with interests in several ventures, acquired a minority interest in ConCreate USL Ltd. ("ConCreate") and a related business, Steel Designed & Fabricators (SDF) Ltd. ("SDF"). The businesses were eventually sold to companies controlled by TriWest Construction Limited Partnership ("TriWest LP"), including ConCreate USL Limited Partnership ("Target LP"). As part of the consideration for the sale, Martin received 25 percent of the outstanding limited partnership units (the "Units") of TriWest LP, and entered into a limited partnership agreement with TriWest LP. In addition, Martin was appointed President of Target LP and SDF and entered into agreements containing restrictive covenants in favour of these companies (the "Agreement"). The restrictive covenants precluded Martin from competing with Target LP and with SDF, from soliciting employees, customers, dealers, agents or distributors of Target LP and SDF and from using any non-public information pertaining to or concerning the respondents.

The geographical reach of the non-competition and non-solicitation provisions was Canada-wide, and also restricted activities that ConCreate and SDF did not engage in at the time of the transaction. The duration of the non-competition and non-solicitation covenants in the agreements ended 24 months after Martin disposed of his direct or indirect interest in the Units. The Partnership Agreement, however, also restricted Martin's ability to dispose of its Units by requiring him to obtain consents from the respondents' and their subsidiaries' senior secured lenders and bonding companies, whoever they may be from time to time.

When Martin's employment with the respondents was terminated less than 6 months after the closing of the sale transaction, contrary to the Agreements, Martin started a company that allegedly competed with the respondents. Target LP and SDF then sued Martin for breach of the restrictive covenants in the agreements and for breach of his fiduciary duties. Shortly thereafter, Martin applied to the court for a declaration that the agreements were unlawful restraints on trade and were therefore unenforceable. When the applications judge dismissed Martin's application, he appealed to the Court of Appeal.

The Law on Restrictive Covenants

The Court of Appeal noted that non-competition and non-solicitation clauses are "covenants in restraint of trade" which are generally considered to be contrary to public policy because they interfere with individual liberty and the exercise of trade. Covenants in restraint of trade are therefore *prima facie* unreasonable. A covenant will only be upheld if it is reasonable, considering the interests of the parties concerned and the public interest in discouraging restraints on trade.

The Court also indicated that, in a court action, the party that seeks to enforce a restrictive covenant has the onus of demonstrating that the covenant is reasonable as between the parties. The party seeking to avoid enforcement of the covenant bears the onus of demonstrating that it is not reasonable with respect to the public interest.

In order to determine whether a restrictive covenant is reasonable, a court will consider the geographic coverage of the covenant, the period of time that it is in effect, and the extent of the activity prohibited in light of the circumstances existing at the time the covenant was made. If the wording of a particular covenant is unclear or ambiguous, so that the person giving the covenant cannot determine what activities are prohibited, or during what time periods or in what geographic locations the prohibition will be in effect, the covenant will be automatically considered to be unreasonable.

The Court also noted that the law draws a distinction between restrictive covenants that are given by an employee to an employer or former employer, and those given or relied on in connection with the sale of a business. The test for the reasonableness of a covenant related to the sale of a business will be less rigorous than the test for the reasonableness of an employee's covenant because business relationships do not typically reflect the imbalance of power that exists in most employment relationships. This means that the courts will generally respect the decisions of knowledgeable individuals with equal bargaining power who chose to enter into contracts with each other.

As well, when a restrictive covenant is given in connection with the sale of a business, the purchaser of the business relies on the seller's promise not to compete or solicit customers in order to protect the goodwill in the business that has been bargained and paid for. The reasonableness of a particular covenant should be judged in light of the circumstances that existed at the time the covenant was made, which include the parties' reasonable expectations about the business' future activities.

On the other hand, the Court noted, the public interest is not always served by enforcing restrictive covenants. A promise not to compete can be seen as "restraining trade" by discouraging free and open competition in the marketplace.

The Verdict

The Court of Appeal allowed Martin's appeal, finding that "the general non-competition and non-solicitation provisions in the Agreements have no fixed, outside limit on their term", which made them unreasonable and unenforceable. In coming to this conclusion, the Court noted that the Agreement contained provisions in which Martin had expressly agreed that (1) the restrictions were reasonable; (2) he had received independent legal advice; and (3) he had negotiated on an equal footing. While the application judge had found that the parties had autonomy when signing the Agreements, the Court of Appeal disagreed. The Court noted that while these are important factors in the analysis, they do not entirely immunize a non-competition clause from scrutiny. Instead, a court must conduct a greater level of independent analysis in order to safeguard the public interest in free and open competition.

What Was Unreasonable?

The Court of Appeal was particularly concerned with the consents that Martin was required to obtain in order to trigger the 24-month non-competition and non-solicitation periods. As the identities of the third parties whose consents would be required for a valid disposition of Martin's Units at any given time was unascertainable, and because the consents could conceivably be withheld indefinitely and arbitrarily, the Court found that the duration of the covenants was indeterminate and therefore unreasonable.

In reaching its conclusion, the Court noted that while most non-competition covenants obtained in a sale transaction begin to run from the time of the sale transaction, the restrictive covenants in this case were not triggered until after Martin had ceased to hold an indirect interest in the Units. It concluded that in the circumstances of this case, tying the general non-competition provisions and the non-solicitation covenant to the period during which Martin had an indirect interest in the Units was unreasonable.

Significantly, the Court drew a distinction between the analysis required for a non-competition covenant in a limited partnership agreement versus that in a unanimous shareholders' agreement, on the basis that parties to a limited partnership have a more limited role in the control or the management of the business. The Court's comment suggests that, had Martin been permitted to take a more active role in the management of the business in which he held the Units, the duration of the covenants would have been considered to be more reasonable.

The Court also found that the range of the activities that Martin was prohibited from engaging in was unreasonable. The non-solicitation clause in the Agreement prevented Martin from communicating or dealing with any persons who were customers, dealers, agents, or distributors of SDF or Target LP, at the time of the sale transaction or afterwards, with respect to any products or services that competed with products or services offered by SDF or Target LP, whether or not offered or planned to be offered by ConCreate or SDF at the time of the sale transaction.

The Court noted that this restriction was effectively broader than the general non-competition provision and went far beyond what was properly required to protect the goodwill of the purchased business. The Court concluded that it was unreasonable for a restrictive covenant given in the context of a sale of a business to extend to activities that were not being carried on or even contemplated by the parties at the time of sale, especially where the person giving the promise not to solicit was involved in the business post-sale or had an ownership interest in the business.

What Received the Green Light?

Although the geographic scope of the restrictive covenants in the Agreements were quite broad, the Court did not find them to be unreasonable. The Court agreed with the trial judge's assessment that the parties envisaged that "the scope of the business was and would be national". Therefore, it was reasonable for the geographic reach of the covenants to be Canada-wide.

Implications for Your Business

If the shareholders in your business have or are thinking about including a non-competition clause in a shareholders' agreement to prevent shareholders from competing with the business after they sell their shares, the *Martin v. ConCreate* case indicates that careful drafting will be required to make sure the clause is reasonable in the circumstances and therefore enforceable. Non-competition clauses that go too far in restricting either the types of business activities the former shareholder can conduct, or the place or time during which the former shareholder can start a competing business, may not be upheld. Similarly, if the shareholders require the approval of a third party such as a lender before they can sell their shares, a court may consider the time limitation to be potentially infinite and find the clause unreasonable.

It is also important to remember that an express acknowledgment by the party to the agreement as to the reasonableness of the covenants will not necessarily safeguard the covenant against a finding of unreasonableness. These clauses may be given some weight by the Court in its assessment of the restrictive covenant; however, they do not trump a court's ability to find that a clause is still unenforceable. Before agreeing to non-competition or non-solicitation clauses in their agreements, therefore, both the corporation and the shareholders should seek legal advice.

If you need help with non-competition or non-solicitation clauses, the members of our Business Law and Commercial Litigation Practice Groups would be pleased to assist you.

PALLETT VALO LLP
Lawyers & Trade-Mark Agents

One of the top Ontario Regional Law Firms as chosen by the readers of *Canadian Lawyer* magazine.

Maria Zawidzki is a member of the Commercial Litigation Practice.

Helen Ferrigan is the firm's Director of Knowledge Management.

Pallett Valo LLP Business Law Practice

Structuring your business, and business proposals, for success requires the right partnerships and specialized expertise. At Pallett Valo, we represent both growth businesses and established enterprises in all sectors. Our specific legal knowledge and wide-ranging experience will empower your business decisions - enabling you to act with confidence and decisiveness to take advantage of all opportunities. We bring a rarely-found enthusiasm, creativity and cost-effectiveness to both your day-to-day legal requirements, and more complex strategic legal needs.

Contact Members of the Business Law Practice

Murray Box mbox@pallettvalo.com
Direct Dial: 905.273.3022 Ext. 240

Olivia Gismondi ogismondi@pallettvalo.com
Direct Dial: 905.273.3022 Ext. 209

Joe Conte jconte@pallettvalo.com
Direct Dial: 905.273.3022 Ext. 217

Murray Gottheil gottheil@pallettvalo.com
Direct Dial: 905.273.3022 Ext. 245

Pallett Valo LLP Commercial Litigation Practice

Our firm has the largest Commercial Litigation department in Peel Region, with the depth and expertise to provide legal advice and representation in complex litigation matters. Our clients are served with advice that is designed to minimize and avoid risks and business disruption through alternative dispute resolution mechanisms, and decisive and aggressive action in the courts when necessary.

Contact Members of the Commercial Litigation Practice

Anna Esposito aesposito@pallettvalo.com
Direct Dial: 905.273.3022 Ext. 260

Paul Guaragna pguaragna@pallettvalo.com
Direct Dial: 905.273.3022 Ext. 281

Anne Kennedy akennedy@pallettvalo.com
Direct Dial: 905.273.3022 Ext. 204

Scott Price sprice@pallettvalo.com
Direct Dial: 905.273.3022 Ext. 221

John Russo jrusso@pallettvalo.com
Direct Dial: 905.273.3022 Ext. 282

Marc Whiteley mwhiteley@pallettvalo.com
Direct Dial: 905.273.3022 Ext. 255

Ted Evangelidis tevangelidis@pallettvalo.com
Direct Dial: 905.273.3022 Ext. 250

Wojtek Jaskiewicz wjaskiewicz@pallettvalo.com
Direct Dial: 905.273.3022 Ext. 285

Francesca Maio fmaio@pallettvalo.com
Direct Dial: 905.273.3022 Ext. 210

Maria Ruberto mruberto@pallettvalo.com
Direct Dial: 905.273.3022 Ext. 206

Bobby Sachdeva sachdeva@pallettvalo.com
Direct Dial: 905.273.3022 Ext. 295

Maria Zawidzki mzawidzki@pallettvalo.com
Direct Dial: 905.273.3022 Ext. 232

This article provides information of a general nature only and should not be relied upon as professional advice in any particular context. For more information about Business Law/Commercial Litigation, contact a member of our **Business Law/Commercial Litigation Practice** at **905.273.3300**.

If you would prefer to receive your bulletins by email, visit www.pallettvalo.com/signup or send an email to marketing@pallettvalo.com.