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CONFIDENTIALITY, NON-COMPETITION AND NON-SOLICITATION COVENANTS – A PRACTICAL GUIDE

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CONFIDENTIALITY, NON-COMPETITION AND NON-SOLICITATION COVENANTS – A PRACTICAL GUIDE:

In a competitive business environment, organizations are constantly looking for an edge. With modern customer and employee mobility, growing reliance on intellectual property and the ease with which information can be shared electronically and otherwise, the need and drive to protect intangible assets is an important fact of conducting business in today's world.

This paper discusses confidentiality, non-competition and non-solicitation agreements as distinct but related tools for protecting the competitive advantage of an organization. The most obvious tool for such protection is a non-competition agreement; however, there are challenges with the enforceability of such agreements. Another means of protecting competitive advantage is to guard confidential information. In this connection, the limited common law right to be free from competition from certain company insiders who have left the business, especially former employees, former partners and vendors of businesses, has to do with protecting a company's ability to safeguard confidential information. Finally, customers and employees of an organization may be protected by requiring a non-solicitation agreement in appropriate circumstances from third parties.

As an interesting note, non-competition payments have featured prominently in the news of late, as Lord Black of Crossharbour's troubles have become well known. Formerly non-competition payments were used as an avenue to receive tax-free payments, an avenue which has since been closed under Canadian tax law. Going forward, confidentiality agreements and non-competition and non-solicitation clauses are expected to return to their roots and protect the intangible assets of a company. A fuller discussion of the tax implications of confidentiality agreements is beyond the scope of this paper.

In respect of each of non-competition, confidentiality, and non-solicitation agreements, there are concerns with respect to public policy, lack of protection to parties without written agreements, and, where the agreements are unduly restrictive, enforceability. This paper is a practical guide to drafting confidentiality, non-competition and non-solicitation agreements.

Confidentiality Agreements

Confidentiality agreements serve an important economic purpose by facilitating arm's length exchanges of information and as an important part of, or prelude to, entering into contractual relationships. Confidentiality agreements are commonly entered into during the negotiation stage of mergers, financings, corporate takeovers and joint ventures in order to allow parties to reduce the risk that confidential information, often an important intangible asset, will be divulged. Confidentiality agreements may also sometimes be used as part of settlement agreements where parties wish to terminate their contracts. Asking employees to sign a confidentiality agreement is also a standard practice. Finally, confidentiality provisions are often included in employment agreements and shareholder agreements.

Courts may find a duty of confidentiality even in the absence of an agreement. However, confidentiality agreements are used to modify common law duties and to set out ground rules for any subsequent dispute.

The common law test for breach of confidence is set out in *International Corona Resources Ltd.* v. *LAC Minerals Ltd.*,[1] in which the Supreme Court of Canada adopted the test employed by the Ontario Court of Appeal in the same case:

(a) the information itself must ‘have the necessary quality of confidence about it’;

(b) the information must have been imparted in circumstances importing an obligation of confidence; and

(c) there must be an unauthorized use of that information to the detriment of the party communicating it.

Finding a breach of confidence will depend heavily on the facts and the context of the disclosure. In most cases, where confidential information is exchanged it will be quite obvious that the information is to be kept confidential. However, because of the uncertainty surrounding a court’s interpretation of the facts, any structured disclosure of confidential information should be protected through means of a confidentiality agreement. Even where a confidentiality agreement in place, questions will arise with respect to the scope of the protection: *i.e.*, whether it covers public information, information received from independent sources and whether the information has been used as a springboard by the recipient. In rare circumstances, courts may find that arm’s length commercial parties owe fiduciary duties and therefore duties of confidentiality.[2] Additionally, courts will find that a duty of confidentiality is an implied term of contracts between banks and their customers.[3]

While confidentiality agreements are not especially hard to enforce, given the subject matter of the agreement, once there is a breach, the harm to the discloser may be irreparable. In addition, damages may be hard to prove or collect. Accordingly, even where a confidentiality agreement is in place, only information which is necessary for the task at hand should be disclosed. The most practical way to protect confidential information is not to disclose it.

Drafting the Agreement
Purpose -Why is Information Being Disclosed

Probably the most important step in drafting a confidentiality agreement actually occurs before setting “pen to paper” – the purpose of the disclosure must be determined. Generally, confidentiality agreements will provide that the confidential information may be used only for such purpose. Accordingly, limiting such purpose is as important as defining the scope of the confidential information. In addition, certain provisions of the agreement may or may not be required depending on such purpose. For example, a confidentiality agreement prepared for both a borrower and a bank that need protection where a syndication arranger shops the bank loan to other parties should provide for disclosures to third parties, allocation of responsibility for third party breach and termination upon

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[1] (1989), 2 S.C.R. 574.

[2] *Cadbury Schweppes Inc.* v. *FBI Foods Ltd.*, [1999] 1 S.C.R. 142.

[3] See *Tournier* v. *National Provincial and Union Bank of England* [1924] 1 K.B. 461 (C. A.) at 480 endorsed in *Canadian Imperial Bank of Commerce* v. *Sayani* (1993), 83 B.C.L.R. (2d) 167 (B.C.C.A.).

the event of the loan's syndication. A confidentiality agreement arrived at in the course of terminating a contract would not include any of those provisions.

Consideration

While consideration is important for any contract, it is important to ensure that consideration has been received in exchange for the promise to keep information confidential. This comes up most often when employees are asked to sign confidentiality agreements long after their employment has commenced. A better practice is to require new employees to sign confidentially agreements at the start of their employment. Otherwise, a court may not view the provision of continued employment as consideration for the confidentiality agreement. If an employee has access to confidential information, the need for a written agreement usually arises immediately. Employers are often unlikely to terminate their employees solely for refusing to sign a confidentiality agreement. Therefore, it is preferable to link confidentiality agreements to promotions or, if necessary, a payment of money.

Defining Confidentiality

Defining which information is confidential is an obvious and early challenge in drafting confidentiality agreements. Some representative examples of confidential information include business plans, customer lists, marketing strategy, proprietary technology, secret formulas, communications, etc. The provider of the information is often tempted to broadly define "information", to include every possible type of information in the definition of the "information" that is to be kept confidential. This approach can result in confusion as to what information is actually covered by the agreement and, potentially, problems with enforcement if the restrictions are viewed by a court as an unreasonable restriction on the recipient's ability to carry on a business or trade. Conversely, the recipient of the information will want to set out in schedules exactly which information and conversations are to be kept confidential in order to identify and limit risk. Where the confidential information is confined to a small number documents provided to the recipient, this approach is workable. Otherwise, particularly where information is provided through a number of different means, such as a combination of oral, written and electronic disclosure, on an ongoing basis, careful thought must be given to delineating which information is or is not confidential.

A simple formulation of confidential information follows with commentary:

> *"Information" shall mean any and all information, data or know-how, whether technical or non-technical, as well as any sample or model, which relate to the Provider's products and is disclosed pursuant to this Agreement to the Recipient by the Provider.*

Commentary:

(1) The definition of Information should be broadened beyond information disclosed pursuant to the confidentiality agreement. Any information provided before the date of the confidentiality agreement will not be protected. Also, if the agreement does not set out a mechanism for disclosing information under the agreement, it may be difficult to distinguish between information provided "pursuant to this Agreement" and other

information, which is subsequently disclosed. This may be a more difficult problem where the information is provided in a variety of formats, such as images, oral and written information and if it is not clearly marked as being provided "pursuant to this Agreement". Alternative formulations may include protecting only information which is marked as "confidential", or information which is or should be reasonably expected to be confidential by its nature, or information which is treated as confidential by the Discloser.

(2) The fact that negotiations are being conducted should be confidential. This is a common but significant omission because in most cases negotiations are not public and making them public at inopportune times may destroy prospective transactions or even invite liability.

(3) The definition of Information should include information provided through professional advisors, such as bankers, lawyers and accountants.

(4) The definition of Information should include analyses or work product created by the recipient based upon the information furnished by the provider. Usually this is just as important as protecting the information provided to the recipient itself. Dissemination of analyses or work product could allow the underlying information to become public. Additionally, the recipient's analysis of the information provided may cast the provider's business in a negative light. If so, further recipients may accept the initial recipient's analysis as fact and thereby damage the provider's future prospects for entering into similar arrangements with other parties.

(5) In the most sensitive cases, the Discloser may require that the Recipient keep a written record of the parties to whom Information is disclosed. Such written record should be deliverable to the Discloser on request.

Confidentiality Obligations

The obligation to keep information confidential is the next important element of a confidentiality agreement. The recipient will likely agree that the information should be kept confidential, however, it is important to create a standard. Advisors should be careful as to the extent of obligations which may apply to them as a result of a client having entered a confidentiality agreement.

A simple formulation of the confidentiality obligation follows with commentary:

The Recipient agrees:

(a) to treat the Information as confidential and with the same care as it would its own proprietary information; and

(b) to take all reasonable precautions to prevent the disclosure of the Information to any third party without the written consent of the Provider.

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Commentary:

(1) This clause should restrict the use of the Information to the purpose of the confidentiality agreement. e.g., The Recipient agrees to use the Information only to evaluate the proposed transaction described above.

(2) Sub-paragraph (a) creates a standard of confidentiality equal to the standard of care for the Recipient's proprietary information. This should be established as a minimum and it should refer to the Recipient's most confidential proprietary information. In addition, the provision should provide for an objective element: *i.e*., the Recipient agrees to keep the Information <u>strictly confidential</u> and with a degree of care which is not less than it would for its own most confidential proprietary information.

(3) Sub-paragraph (b) restricts disclosure to third parties. However, advisors and employees often require access to the Information in order to evaluate the proposed transaction. Accordingly, the confidentiality agreement could provide that such parties must execute a similar confidentiality agreement or acknowledge that they are bound by the agreement between the provider and the recipient. At a minimum, the Recipient should indemnify the provider for any breach of the confidentiality agreement by its advisors and employees.

Disclosures Required by Law or Government Authority

Usually, disclosures of confidential information which are required by law are exempted from the Recipient's obligation to maintain the information's confidentiality.

A *simple* formulation of the exemption follows with commentary:

The Recipient shall be permitted to disclose any Information (and the fact that the Information has been made available to it and that discussions or negotiations are taking place concerning the transaction or any of the terms, conditions or other facts with respect thereto) if the Recipient is so required by applicable law or regulation or any governmental agency or other regulatory authority

Commentary:

(1) This provisions should provide for advance written notice, if possible, by the Recipient to the Discloser of such requirement and, in any event, written notice as quickly as commercially reasonably possible.

(2) The Discloser should be expressly entitled to oppose this required disclosure and the Recipient should be obligated to assist the provider's opposition in all reasonable ways. It may also be possible to negotiate an obligation on the part of the Recipient to oppose such required disclosure.

(3) The obligation to pay the costs of opposing any required disclosure may be negotiated. It is the Discloser's information and any opposition to required disclosure is likely for

the economic benefit of the Discloser. However, if the Recipient did not have such information, the need to defend its disclosure may not have arisen.

(4) In order to more strictly define required disclosure, it may be appropriate to add the requirement that the Recipient obtains the advice of counsel prior to any disclosure.

Information that is not Confidential

Notwithstanding the definition of confidential information, there are certain exclusions which are customary. These exclusions are important because they permit the recipient to differentiate between with information it received independent of the disclosure by the provider and the information being offered together with the confidentiality agreement. Without this protection, the recipient cannot deal with the independent information as effectively after the disclosure as it could before, and is potentially worse-off for having received the information from the provider. Additionally, in certain circumstances the provider may have incentive to over-disclose in order to prevent the recipient from dealing with the information received.

A simple formulation of the exclusions follows with commentary:

The Recipient shall be relieved of any and all obligations under Paragraph 2 of this Agreement regarding Information which:

> *(a) was known to the Recipient prior to its receipt from the Provider, as evidenced by the Recipient's written records;*
>
> *(b) was generally available to the public, or which becomes generally available to the public through no fault attributable to the Recipient; or*
>
> *(c) is hereafter made available to the Recipient for use or disclosure by the Recipient from any third party having a lawful right to do so.*

Commentary:

(1) This provision attempts to deal with the evidentiary problem posed by information already in the Recipient's hands by resort to its written records. It should be noted that oral information and many documents do not come time and date stamped and most companies do not keep a log of information in their possession. The obligation to keep detailed records of information previously received is an onerous which many recipients would be wise to avoid. An information provider that is serious about these records should also bargain for the right to inspect or audit them periodically.

(2) It may be difficult to determine when information has become available to the public. Courts have decided that information was in the public domain when a report was handed to "over 20 companies and persons in Calgary, to one or two in Edmonton and

to several in Denver."[4] It is not clear whether the above provision would be so liberally interpreted.

(3) The recipient may be liable for disclosing information received from third parties where the third party received it unlawfully. The recipient should insist on a standard of "reasonable belief" because it may not be able to evaluate the legality of third party disclosures.

(4) Sometimes the information is public and the provider is supplying the recipient with its analysis. In such case, the provider may wish to protect that analysis by tailoring the exclusions so that they do not apply to a particular combination of information

Return and Destruction of Information

Where a confidentiality agreement is used to facilitate future transactions, it should cover the possibility that negotiations will break down and the parties will walk away from the proposed deal. In that case, the provider will want its information returned or destroyed.

A simple formulation of this provision follows with commentary:

The Recipient agrees to return to the Provider or destroy all Information promptly upon written request of the Provider without retaining any copies thereof unless prohibited from doing so by applicable law or by legal process.

Commentary:

(1) The recipient will want to retain its own analyses and any value it has added or paid its advisors to produce. The recipient may carve out information that it is required to retain pursuant to professional requirements (e.g., accounting or legal).

(2) Also, the provider may wish to add a subclause which requires the recipient to certify that all information has been returned or destroyed.

Injunctive Relief

In many cases, once there is a breach of a confidentiality agreement, the harm to the Discloser may be irreparable. In addition, damages may be hard to prove or collect. Accordingly, the provider will want to include a provision entitling it to injunctive relief. Unfortunately for the provider, it is not clear whether such provisions are enforceable. A contractual right to injunctive relief is not conclusive. It is only one factor, albeit an important one, in the exercise of the discretionary power of the court.[5] However, the presence of an injunctive relief clause may emphasize to the recipient the seriousness of any unauthorized disclosure.

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[4] *Ridgewood Resources Ltd.* v. *Henuset* (1982), 35 A.R. 493 at 503.

[5] *Horizon Custom Builders Ltd.* v. *Behrens* (2001), 160 Man. R. (2d) 296.

A simple formulation of this provision follows:

The Provider will be entitled to any injunction and/or specific enforcement of the terms hereof in addition to any other remedy to which such member may be entitled, at law or in equity, in respect of any breach or threatened breach of this Agreement.

No Representations and Warranties; No Obligation to Disclose

When confidentiality agreements are entered in contemplation of a transaction, the context, the recitals, and even the provisions of the agreement may create a presumption that the information will be disclosed or that it is accurate. Accordingly, it may be important to state that no representations and warranties are made pursuant to the agreement. The representations and warranties will usually be negotiated as a part of the definitive agreement. The provider will also want to document that it is under no obligation to provide any information and that it is not liable, pursuant to the confidentiality agreement, for failure to provide information.

A simple formulation follows:

The Recipient acknowledges and agrees that the Provider has not, does not and will not give any representations or warranties, express or implied, concerning the accuracy or completeness of the Information and that the Provider shall not have any liability whatsoever to the Recipient for any transaction entered into, or not entered into, or any other act, omission or decision made or taken, relying upon or in any way affected by, the Information. The Discloser shall have no obligations to disclose any Information by virtue of entering into this Agreement and for greater certainty, any disclosure shall be at the sole discretion of the Discloser.

How Long Should Information Remain Confidential?

The duration of the confidentiality obligation may be a matter of some sensitivity where competitors are concerned. The Recipient does not want to unduly restrict itself from competition. The Discloser may want the restriction to last indefinitely

Non-Competition Covenants

The law has traditionally been hostile to restrictive covenants. As a general rule, non-competition clauses (usually referred to as “non-competes”) are considered covenants in restraint of trade and are void on public policy grounds unless they can be justified as reasonable both in the interests of the public and in the interests of the parties. In addition, there are concerns pursuant to the *Competition Act* which are beyond the scope of this paper.

Common Law

In its seminal decision on non-competes, *J.G. Collins Insurance Agencies* v. *Elsley*,[6] the Supreme Court of Canada held that a non-compete will only be enforceable when, based upon the particular circumstances, the non-compete reasonably balances the interests of the public and the interests of contracting parties:

> *The principles to be applied in considering restrictive covenants of employment are well established... a covenant in restraint of trade is enforceable only if it is reasonable between the parties and with reference to the public interest. As in many of the cases which come before the courts, competing demands must be weighed. There is an important public interest in discouraging restraints on trade, and maintaining free and open competition unencumbered by the fetters of restrictive covenants. On the other hand, the courts have been disinclined to restrict the right to contract, particularly when that right has been exercised by knowledgeable persons of equal bargaining power. In assessing the opposing interest the word one finds repeated throughout the cases is the word "reasonable".*
>
> *The test of reasonableness can be applied, however, only in the peculiar circumstances of the particular case. Circumstances are of infinite variety. Other cases may help in enunciating broad general principles, but are otherwise are of little assistance.*[7]

Because the context of the non-compete marks the lines of reasonableness, parties should tailor non-competes carefully or risk a court's refusal to enforce them. Public policy considerations help to distinguish between using non-competes in the employment context and in the more permissive circumstances of a sale of a business:

> *The distinction made in the cases between a restrictive covenant contained in an agreement for the sale of a business and one contained in a contract of employment is well conceived and responsive to practical considerations. A person seeking to sell his business might find himself with a unsaleable commodity if denied the right to assure the purchaser that he, the vendor, would not later enter into competition.*[8]

The reasonableness of a non-compete will be determined based on whether the non-compete is:

(a) certain and clear;

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[6] [1978] 2 S.C.R. 916 [hereinafter *Elsley*].

[7] *Ibid.* at 923-4.

[8] *Ibid.*

(b) reasonable as to the prohibited activity – only legitimate proprietary rights will be protected and blanket restrictions on the freedom to compete are generally unenforceable;

(c) reasonable as to duration; and

(d) reasonable as to geographic area.

The most significant challenge in drafting non-competes is successfully sculpting the terms to protect the proprietary rights which are otherwise at risk without drafting overbroad language that may be unenforceable. However, a threshold question that should be addressed is which jurisdiction's law should govern the interpretation of the non-compete. A full discussion of the enforcement of foreign judgements is beyond the scope of this paper; however, a brief discussion is warranted.

Non-competes governed by Ontario law can be rendered unenforceable (void as against public policy) by terms that are too broad. Parties with a "real and substantial" connection to another jurisdiction should consider the advantages and drawbacks of selecting the law of the foreign jurisdiction. This is an important consideration when the non-compete needs a longer duration in order to protect long-term investments.

Foreign Law

A recent Supreme Court of Canada decision extended the law governing enforcement of inter-provincial judgments to cover foreign judgments as well. Although this jurisprudence makes available a defence of public policy, its application is limited. A foreign judgment will not be enforced if it is "contrary to the Canadian concept of justice", or where the outcome is so egregious that it would "shock the conscience of, or be unacceptable to, reasonable Canadians". The Court cautioned that the defence, if used successfully, would result in an impeachment of the foreign law upon which the foreign judgment was based and courts should, therefore, not use this remedy lightly. The public policy defence will not prevent enforcement of foreign judgments just because the claim would yield a different result in Canada.[9]

Parties seeking more robust non-competes should take care to ensure that they have received legal advice on how the foreign jurisdiction treats and enforces non-competes. Parties should also ensure that a "real and substantial" connection actually does exist with the foreign jurisdiction or the judgment will not be enforceable in Canada. Because of the added time and expense involved in negotiating non-competes under foreign law, it is important to decide whether additional protection that might be available is really essential. Lawyers acting for the party limited by the non-compete should make the point that using foreign law for the non-compete will add to the cost of the deal and could be viewed as making the agreement less certain, and therefore more prone to abuse and vulnerable to unnecessary litigation.

Further questions arise with respect to interpretation of non-competes and how a court will deal with an agreement that goes farther than is reasonable.

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[9] *Beals* v. *Saldanha*, [2003] S.C.J. No. 77 at paras. 71-77.

Defining Competition

A non-compete must provide a clear and certain definition of the competitive activity that it prohibits. In the employment context, non-competes can be used to clarify and expand fiduciary duties which would otherwise exist. Consideration should be given to whether a non-solicit (discussed below) would suffice. Use of non-competes for other employees is at the risk of an inability to enforce such provisions. In the context of a sale of a business, non-competes are effectively more enforceable; however, care should be taken to tie the sale of the business to the consideration which forms part of the non-compete.

Because of the variety of legal structures which may be available to a potential competitor, it is important to broadly set out prohibited interests pursuant to the non-compete. Also, as a practical matter, it may ultimately be easier to enforce a non-compete given by an individual. Consider for example that the shareholders of an organization which has given a non-compete could simply forma new company to carry on the competition. It is customary to carve out ownership of shares in a public company as not constituting a breach of a non-compete.

In cases where competitive activity is potentially harmful but more difficult to cover under the agreement, the non-compete may include disclosure provisions. For example, in the context of the sale of a family business, it is not unusual to require that the vendor disclose to the purchaser if a family member takes an interest (financial, as an employee or otherwise) in a competing business. Although a disclosure provision does not provide the same level of protection as entering into an additional non-compete, it provides a "heads-up" to the purchaser that competitive threats are emerging and the vendor may be quietly violating the non-compete.

If the parties wish to exclude particular activities from the non-compete's application, they should do so by way of an express carve-out of the permitted activity. Precision is very important in drafting this carve out because general language in the carve-out could undermine the general prohibition on competition.

To be effective, the definition of prohibited competitive activity must show that the parties turned their minds to assessing which proprietary interests are at stake.

The following is a sample formulation of the prohibited interests in a competitor:

The [contracting party] shall not directly or indirectly, either individually on his own account or as a partner, officer, director, shareholder, agent, employee, manager, owner, adviser or financial banker, or in any other way affiliated with any person, firm, association, venture, corporation or business, carry on or be engaged in, or concerned with or interested in, or advise, lend money to, guarantee the debts or obligations of, or permit his name or any part thereof to be used or employed by any person, firm, association, syndicate or corporation concerned with or engaged in a business similar to that carried on by the Corporation and competitive therewith. Notwithstanding the above, this paragraph shall not be construed to prohibit such Shareholder or such Principal from owning less than five (5%) of the securities of a corporation which is publicly traded on a securities exchange or over-the-counter.

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Commentary:

(1) The above provision does not set out the business of the Corporation. Since a corporation may have engage in a variety of business over time, there should be a description of the business or, at a minimum, a time reference for defining the business of the Corporation.

(2) The geographic scope duration of the non-compete are discussed below.

Geographical Scope

There is no rule of thumb as to what a "reasonable" geographic limit is in a particular case. Reasonableness may depend on a variety of factors including the geographic scope of competition being limited and industry practice. For example, in the franchising context, large, national chains with numerous franchises may find it difficult to keep former franchisees from operating a competitive business in any territory where a franchise is located.[10] In the employment context, at least one court has found that where an employee violated a non-compete which prohibited competition anywhere in Canada only to go on to sign a similar agreement with the competing business, the national scope of prohibited competition may be interpreted as standard practice in the industry and therefore more reasonable than in other contexts.[11]

Like every aspect of non-competes, analysis of geographic scope is very fact-driven. Parties should strive to match restrictions on competition to reasonable competitive threats. Purchasers of geographically limited businesses will have difficulty enforcing expansive geographic restrictions against the vendor unless there is some reason to believe that the purchaser considered the possibility of expansion to be important to transaction. A purchaser may be able to convince a court of its ambition to grow the purchased business if it can produce supporting evidence such as strategic and marketing plans, evidence of sales calls into the new territory following the agreement and evidence of actual growth achieved prior to the vendor's breach. Again, the restriction on competition should match the protected interest.

Duration

There is no rule of thumb as to what amount of time is "reasonable" for a non-compete. Non-competes typically run between one to two years long. The general consensus is that longer terms risk being found unenforceable but the particular circumstances must be considered in assessing reasonableness. A five year ban on the provision of food services to institutional clients was upheld in the context of a sale of an institutional food services because the business depended upon the development of long-term relationships with clients. Without the five-year non-compete, the vendors, who were very well known in British Columbia in this segment of the food services industry, could have started a competing business and thereby immediately damaged the value of the business they

[10] *Pizza Pizza* v. *Gatto*, [1996] O.J. No. 4087 (Ont. Gen. Div.) (QL).

[11] *Ash Temple Ltd.* v. *Croney* (2000), 46 O.R. (3d) 561 (Ont. C.A.).

sold to the purchasers.[12] In the more restrictive context of employment relationships, five year bars on competition are likely too long in most cases.

Because of the uncertainty surrounding interpretation of non-competes, for a time a practice developed of drafting the non-compete as a menu of terms and asking the court to choose among the alternatives by using the “blue pencil” rule. The “blue pencil” rule involves “drawing a line with a blue pencil” through the portions of an agreement that are void, *e.g.* for illegality or breach of public policy. In *Canadian American Financial Corp. (Canada) Ltd.* v. *King*,[13] Lambert J.A. of the British Columbia Court of Appeal frowned on this practice and suggested that provisions so drafted would be void for uncertainty:

> *It is no function of the courts to act as de facto arbitrators over clauses that are drawn as alternatives. If the covenant says that the employee will not compete in (a) Canada, (b) British Columbia, and (c) Vancouver, for (i) ten years, (ii) five years, and (iii) one year, for example, the courts ought not to use the “blue pencil” rule to make an agreement for the parties that they have been unable to make for themselves. Such a clause, where one alternative encompasses another, but on a wider scale, is, in my opinion, void for uncertainty and should not be made valid by severance. The only point on which the terms of the covenant are clear is that the covenant is to cover at least Vancouver for at least one year. The parties could have said that. If they failed to do so, then they will risk losing the whole clause.*[14]

In the Supreme Court of Canada’s recent decision in *Transport North American Express Inc.* v. *New Solutions Financial Corp.*, released in February 2004, the Court considered the “blue pencil” rule in a the context of criminal rates of interest.[15] The Court endorsed an approach that would most closely reflect the bargain struck by the parties. If the spirit behind the Court’s decision can be applied with respect to non-competes, then courts will give the greatest possible effect to the agreed upon portions of the agreement. The Court reasoned that any use of a “blue pencil” or severance, to remedy illegal contracts, results in a change to the agreement as struck by the parties. However, courts should strive for minimal damage to the bargain the parties intended. Therefore, in a non-compete like the one suggested by Lambert J.A., excerpted above, the court would, at minimum, give effect to the employee’s commitment not to compete in Vancouver for at least one year. It is important to note that the *Transport* decision has not yet been applied by lower courts in any context and was not occasioned by interpretation of a non-compete. Consequently, uncertainty still exists with respect to the “blue pencil” rule. It will remain inadvisable to draft a menu of restrictions until *Transport* is used to explicitly discredit Lambert J.A.’s decision.

Consideration

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[12] *Restauronics Services Ltd.* v. *Forster* (2001), 13 C.P.R. (4th) 1 (B.C.S.C.) at para. 91.

[13] (1989), 60 D.L.R. (4th) 293.

[14] *Ibid.* at 307.

[15] [2004] S.C.C. 7 [hereinafter *Transport*].

Non-competes have begun to be struck down with increasing frequency in the employment context where a court finds that no consideration was given in exchange for the restrictive covenant. Although the traditional rule says that continued employment can constitute consideration, where there is no evidence of forbearance or any suggestion that failure to execute the non-compete would lead to termination, the non-compete may be vulnerable. Purchasers of businesses should be careful to provide some consideration to employees if the terms of their employment are to change following the purchase. Alternatively, carefully document the nature of consideration actually provided through continued employment and the fact that employee's jobs are actually at risk.

Severance

The doctrine of severance is also potentially restricted by the Court's decision in *Transport.* Because the Court has endorsed a more flexible approach to interpretation of some illegal contracts, it is arguable that severance will less frequently be drawn upon where a less intrusive interpretation is possible. As discussed above, as of this writing it is impossible to be certain that *Transport* applies beyond the criminal rate of interest context. Therefore, parties should draft severance clauses very carefully to give effect to the maximum restriction on competition permitted by law if the limitations stipulated in the contract are unenforceable.

Injunctive Relief

The party seeking the non-compete will want to include a provision entitling it to injunctive relief if the other party is found to be competing, in violation of the agreement. However, as mentioned with respect to confidentiality agreements, such a provision may not be enforceable. Most non-competes include an injunctive relief clause because with each passing day competition inflicts more and more damage upon the party which expected to benefit from the non-compete. Damages may be hard to prove and may not be considered satisfactory by a party to a breached non-compete.

Non-Solicitation Clauses

Non-solicitation clauses (referred to herein as "non-solicits") are often considered an adjunct or counterpart to a non-compete. A better view, the non-solicit plays a slightly different role. While non-competes can raise serious questions regarding enforceability, non-solicits are less likely to be struck down for being overreaching because their aims are much more restrained and easily defined. Although solicitation of current customers for similar business would certainly be caught by most non-competes, using the non-solicit together with a non-compete is a "belt and suspenders" approach and can provide some useful protection if the non-compete is unenforceable.

Don't Use a Non-Compete when a Non-Solicit will do

In *Elsley*, the Supreme Court of Canada rejected the application but not the principle that it is unreasonable to use a non-compete where the relevant business interests would be adequately protected by a non-solicit. The Court found on the facts of the case that Mr. Elsley, who had sold the insurance agency in 1956 and stayed on to manage the business until 1973, was such a dominant force in the business that a non-solicit alone would not have sufficed to protect the business. Mr. Elsley's name had been part of the business name over the seventeen years that followed the sale. Also, Mr. Elsley dealt with the customers almost to the total exclusion of the purchaser. When Mr. Elsley left to start a rival business, he took several salespeople and numerous customers with him in violation of a non-compete which precluded his being engaged in the business of an insurance agent for five years following cessation of his role as manager of the agency.

The Court concluded as follows:

> *Whether a restriction is reasonably required for the protection of the covenantee can only be decided by considering the nature of the covenantee's business and the nature and character of the employment. Admittedly, an employer could not have a proprietary interest in people who were not actual or potential customers. Nevertheless, in exceptional cases, of which I think this is one, the nature of the employment may justify a covenant prohibiting an employee not only from soliciting customers, but also from establishing his own business or working for others so as to be likely to appropriate the employer's trade connection through his acquaintance with the employer's customers…*
>
> *It is difficult to envisage a factual situation in which an employee would be in a better position than that of Elsley in the present case, to obtain 'personal knowledge of and influence over the customers of his employer'…*
>
> *Elsley testified that he did not solicit former clients; notwithstanding, 200 clients switched their custom to him… [a] covenant against solicitation 'is difficult to enforce; it is difficult to show breach and difficult to frame an injunction'. The difficulty is demonstrated in this case. Does an advertisement which comes to the attention of former clients amount to solicitation? Was there solicitation by Elsley? I need not attempt to answer those questions. The point is that a non-solicitation covenant, in the circumstances here found, would have been meaningless.*[16]

Although the Court in *Elsley* did not find that a non-solicit would have sufficed, the judgment left open the possibility that in some cases courts could resort to requiring non-solicits where the non-compete was too far reaching. Because the purchase of a business context is more permissive with respect to non-competes and, perhaps, because the non-compete upheld in *Elsley* was actually quite intrusive, the question of whether a non-solicit would suffice has arisen again in the employment context.

In *Lyons v. Multari*,[17] Ontario Court of Appeal considered an employer and employee, both of whom were oral surgeons, who had entered into a brief non-compete that limited where Dr. Multari could practise his profession if he chose to leave Dr. Lyons' Windsor, Ontario office. The non-compete read: "Protective covenant. 3 yrs - 5 mi." Within two years after their agreement, Dr. Multari

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[16] *Elsley*, *supra* at ● paras. 19, 22, 23.

[17] (2000), 50 O.R. (3d) 526.

had resigned from his employment and had opened a competing oral surgery practice in Windsor. In doing so, Dr. Multari appeared to contravene the non-competition clause.

In analyzing the non-compete, the Court found that Dr. Lyons was legitimately protecting a proprietary interest and the geographic and temporal limitations were reasonable. However, the Court found that this was not one of those “exceptional cases” where a “simple non-solicitation clause would not suffice” to adequately protect the employer. The Court described the non-competition clause as a “more drastic weapon in an employer's arsenal”. Whereas a non-solicitation clause “merely” prohibits a departing employee from soliciting the customers of his or her previous employer, a non-competition clause is directed to keeping the former employee out of the employer's business.

The Court distinguished the facts in *Elsley* because, unlike Mr. Elsley, Dr. Lyons was the dominant figure and Dr. Multari simply handled the patients who were referred to him. Dr. Multari was not the front man, or principal contact person, for dentists who referred business to Dr. Lyons. The Court also noted that Dr. Multari had filled the position of a “normal associate” in the plaintiff's practice, not a “special role” in the employer's business, similar to a senior executive of long service.

It is important to note that a courts will not always follow the *Lyons* reasoning. Where business will naturally flow to the competitor even without active solicitation by the party bound by the non-compete, it is more likely that a non-solicit will not adequately protect the proprietary right at stake.

Non-solicits will be evaluated for reasonableness in a manner similar to non-competes. Because non-solicits focus on the value of the protected party’s proprietary interest in its relationships, geographic scope is not usually a factor. If there is no evidence that breach of the non-solicit will cause a loss to the protected party, the non-solicit may not be enforced. For example, where the protected party does not have a proprietary interest in the skill of the employee and there is no evidence of customer loyalty, a court may refuse to enforce a non-solicit.

Other Non Solicitation

In most business purchases, non-solicits deal with solicitation of customers of the purchased business. It is also important to consider whether a clause restricting solicitation of employees or suppliers should be included. Employees often have direct customer relationships and know-how that they can bring with them to a competing business. Additionally, they will have access to confidential information that could be used by a vendor after a non-compete has expired. Therefore, it may be advisable to extend amount of time for which solicitation of employees is prohibited beyond the life of the non-compete. With respect to suppliers, there may be an important or sole source supplier to a particular business which brings competitive advantage.

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