A MATTER OF EFFECT OVER FORM: COURT APPROVES NOVEL APPROACH TO RESTRICTIVE COVENANTS

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In light of the traditionally intense scrutiny non-compete and non-solicit clauses face from the courts, employers have been increasingly turning to creative and novel contractual tools for protecting their interests and recovering costs when an employee turns into a competitor.

In a recent decision, Rhebergen v Creston Veterinary Clinic Ltd, 2014 BCCA 97, the British Columbia Court of Appeal upheld as enforceable a novel restrictive covenant requiring a former employee to pay a certain amount in the event they began to compete with their former employer.

In what may come to represent the beginning of a significant shift in the drafting of restrictive covenants, Rhebergen suggests that the Court will be more likely to enforce a restrictive covenant that merely inhibits rather than prohibits competition.

Background Facts

Dr. Rhebergen, a newly qualified veterinarian, entered into an associate agreement with Creston Veterinary Clinic ("CVC"), an established veterinary clinic located in Creston, British Columbia. Dr. Rhebergen's associate agreement set out that she must pay a certain amount of money to CVC if her employment with the clinic ended and she "set up a veterinary practice" in Creston, B.C. or within a 25 mile radius of CVC's place of business (the "Clause"). Under the terms of the Clause, if Dr. Rhebergen "set up" a practice within 1 year of the termination of her contract she would be required to pay $150,000 to CVC; within 2 years of termination, $120,000; and within 3 years of termination, $90,000.

After fourteen months, the employment relationship soured and Dr. Rhebergen tendered her resignation. CVC rejected her resignation on the grounds that the terms of the associate agreement did not permit her resignation, and promptly terminated the Dr. Rhebergen for cause.

Five months after termination, Dr. Rhebergen initiated legal proceedings, requesting an order declaring the Clause unenforceable and stating her intention to "set up" a mobile veterinary practice in the area.

Trial Decision

At trial, Mr. Justice Betton found that the Clause was a restraint on trade and that in order to be enforceable, the Clause must meet the standard test for an enforceable restrictive covenant. The standard test is well established at law and requires that the Clause be clear and unambiguous in its drafting as well as reasonable in terms of its length, geographic scope, and the activities prohibited. The court will also look to overall fairness and whether the restraint of trade is reasonable in terms of the public interest.

The trial judge held that the operative phrase "sets up a veterinary practice" was ambiguous; citing a series of hypothetical interpretations of the phrase.

Further, while the court held that the area contemplated by the Clause was not a concern, the three year length however, was "too long" when taking into account the fact that the restraint would operate for a duration of more than 2 ½ times the length of her employment.

With respect to the activities prohibited, the Court held that although the Clause did not explicitly prohibit any activities, it was, in "its essential character," a non-competition clause. It is noted that the courts are reluctant to enforce non-competition clauses and will likely refuse to do so where a non-solicitation clause would have sufficed to protect the interests of the employer.

The trial judge paid particular attention to the question of whether the sum to be paid was an unreasonable penalty or the reasonable compensation of costs related to mentoring, training, and projected losses to goodwill and revenue. While recognizing that costs in this context cannot be precisely calculated, the Court held that the amount was not a genuine estimation of costs, was excessive, and therefore represented a penalty which imposed an unreasonable restraint of trade.

Appeal Decision

The British Columbia Court of Appeal, in a split decision, held that the Clause was reasonable and not ambiguous, allowing the appeal and enforcing the Clause. Mr. Justice Lowry's dissent represents the bulk of the decision, with the majority accepting his reasoning on all issues except with respect to ambiguity.

An important element of the appeal decision concerns the approach for determining whether a clause presents a restraint of trade in the employment context. Mr. Justice Lowry's discussion on this point, which is adopted by the majority, canvasses the case law on whether the court ought to take a ‘functional' approach, which asks whether the clause at issue attempts to, or effectively does, restrain trade versus taking a ‘formalist' approach, in which the clause must be structured as a prohibition against competition in order to constitute a restraint on trade.

Ultimately, against a "background of conflicting authority," the BCCA adopted the functionalist approach as the preferred legal basis for determining whether clauses that "burden employees with financial

consequences... they would not otherwise have for engaging in post-employment competition constitute a restraint on trade."

It is noted however that the court's decision on this point is couched in language that restricts the use of this approach to this particular context. Further, Justice Lowry's dissent recognizes conflicting case law in Ontario, where despite mid-century precedent employing the formalist approach, a recent decision of the Ontario Superior Court of Justice appears to endorse the functionalist approach. In light of these decisions, it is far from settled whether a court will adopt the functionalist approach in all situations related to restrictive covenants in the employment context.

With regard to the trial judge's finding that the amount to be paid constituted an unreasonable penalty; the BCCA unanimously held that the amount was not a penalty but in fact, compensation for the costs incurred by CVC in training Dr. Rhebergen. Costs which, on the evidence, the Dr. Rhebergen acknowledged were reasonable.

The majority held that when analyzing a clause for potential ambiguity, the courts must look to the "plain and ordinary meaning of the impugned words, not in isolation, but in the context of the agreement as a whole and the [surrounding circumstances] in which the agreement was reached."

On the evidence, the majority found that Dr. Rhebergen understood the clause, in particular what it means to "set up a veterinary practice" and as such, it could not be said there was any ambiguity in this case. The majority also adds, in reference to the dissent, that a clause that "falls short of being 'definitive' in all imaginable circumstances" is not necessarily ambiguous.

Key Takeaways for Employers

In the context of increasingly novel approaches to post-employment covenants, based on the decision in Rhebergen, the adoption of the functionalist approach signals that courts will afford employers with reasonable creative licence when drafting covenants while continuing to grant employees protection against ambiguous and unreasonable restrictions.

Employers must be aware that clauses which do not prohibit but inhibit post-employment competition or solicitation will still likely be held to be a restraint of trade and subject to the standard reasonableness analysis outlined above. However, as a result of this decision, Courts may be more amenable to enforcing clauses which put a price on competition rather than barring it outright.

With respect to clauses which require a set amount to be paid in the event the former employer competes, the amount prescribed in the clause ought to be based on a clear calculation of objective evidence. In this case, the employer based the amount on its costs to mentor, train and provide equipment to the employee, as well as an

estimate of the effect of competition by the employee on their volume of business and goodwill. A key takeaway for employers is that, when contemplating the inclusion of a compensation clause in an employment contract, the employer ought to base the amount on a best efforts calculation of the anticipated loss connected with an employee leaving and competing with the employer.

In sum, the drafting of restrictive covenants remains a highly circumstantial and detailed practice that must be undertaken carefully and preferably with the assistance of legal counsel.

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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