HOW TO PROTECT BUSINESS PROPERTY AND INFORMATION IN COMMERCIAL TRANSACTIONS

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A sustainable competitive advantage in today's crowded business environment requires a combination of several factors, including sound market awareness, innovative business ideas, and customer loyalty. A competitive advantage also requires staying one step ahead of the competition, meaning opportunistic companies are constantly trying to gain the upper hand by uncovering and exploiting the business property of their competitors.

In order to try to prevent the exploitation of their business information and property interests, prudent organizations safeguard such interests through a variety of different legal and other methods. This is particularly true in the case of mergers, acquisitions, and other commercial transactions, pursuant to which a high volume of sensitive and confidential information typically changes hands.

This paper will discuss various legal methods that parties can use to protect their proprietary interests in the context of commercial transactions, including confidentiality agreements, non-competition and non-solicitation covenants, and intellectual property assignment and licensing agreements. As will become apparent, it is crucial that the need for and appropriateness of such legal protections be carefully identified and considered on a case-by-case basis, taking into account such factors as public policy, reasonableness, and – most importantly – enforceability.

Confidentiality Agreements

Confidentiality agreements (also referred to as non-disclosure agreements or "NDAs") are often entered into during commercial transactions, particularly at or prior to the negotiation and due diligence stages, in order to reduce the risk that confidential information will be improperly disclosed.

Confidentiality covenants are also commonly included in various employment or commercial agreements pursuant to which, for example, the purchaser may terminate its relationships with certain of the seller's executives, employees, suppliers and others following closing.

As a starting point, parties to a commercial transaction have a general and mutual duty of confidentiality under the common law. In this regard, the common law test for misuse of confidential information was confirmed by the Supreme Court of Canada in *International Corona Resources Ltd v LAC Minerals Ltd*.[1] According to the Court, the following three factors must be present in order to establish a breach:

1. the information must "have the necessary quality of confidence about it";
2. the information must have been imparted in circumstances importing an obligation of confidence; and
3. there must be an unauthorized use of that information to the detriment of the party communicating it.[2]

The courts have confirmed that the common law duty of confidentiality also extends to executives, employees, suppliers, and other similar third parties who are exposed to confidential information, such as pricing data or customer lists.

A related consideration is a potential duty as a fiduciary. Where a fiduciary relationship exists between employer and employee, such as in the case of senior executives and certain key employees, the duty of confidentiality may be "larger" and "more exacting".[3] For example, the courts have held that in addition to refraining from improperly using trade secrets and confidential information belonging to the employer, fiduciaries must refrain from using knowledge regarding the relationships between the employer and its customers, suppliers and others in order to interfere with those relationships.[4]

Despite the common law duty of confidentiality and possible fiduciary duties, parties to a transaction should insist on written confidentiality agreements. First, confidentiality agreements permit the parties to define the scope of protection and permissible disclosure. Second, the parties may establish procedures for the handing of confidential and proprietary information, including requirements regarding the return or destruction of information upon completion of its use. Third, the parties may establish the duration of the confidentiality obligation. Finally, the parties may prescribe the appropriate remedy in the event that confidentiality is breached.[5]

While confidentiality agreements are generally readily enforced, parties must take care to resist the urge to define confidentiality overly broadly, as this could lead to a finding by a court or tribunal that the agreement is an unreasonable restriction on the ability to carry on business or trade. If the court or tribunal makes such a finding, the agreement may be held to be unenforceable, and only the less onerous common law duty of confidentiality would govern a misuse of confidential information.

Non-Competition Covenants

Non-competition covenants may be used in an effort to protect business property and interests. A non-competition covenant precludes an individual from engaging in activities that compete with the business of the party receiving the covenant.

It is fundamentally important when considering non-competition covenants to recognize the distinction between such covenants entered into in the context of a sale of a business or in an employment relationship.

In the employment context, the courts have generally taken the view that non-competition covenants are an unnecessary restraint on trade. To that end, such covenants are often held unenforceable unless they arise in exceptional circumstances and are reasonable in both duration and scope. In addition, the party seeking to enforce the covenant will bear the onus of providing that the restriction is reasonable.

On the former point, the leading case of *Lyons v Multari* [6] established that the courts will generally not enforce a non-competition clause in an employment relationship where a non-solicitation covenant would adequately protect the employer's interests, and a non-solicitation covenant will be adequate in all but exceptional cases.[7]

On the latter point, a critical question is whether the employer, in seeking to protect its legitimate business interests, overreached in the formulation of the covenants.[8] In order to answer this question, the courts often closely scrutinize each of the following three factors:

1. the geographic scope of the restriction;
2. the activity that is restricted; and
3. the time period of the restriction.[9]

Prior to considering the reasonableness of the covenant, the party seeking enforcement must have a legitimate or proprietary interest to protect. In an employment context, the non-competition agreement may be protection for the employer's proprietary interest in its relationships with clients.[10]

In a recent case in the context of franchises, the Court held that franchisors effectively lose the protection of non-competition covenants if the franchise does not have a legitimate interest to protect. In *MEDIchair LP v DME Medequip Inc*, a franchisee changed the business name but continued operations after the end of a franchise agreement. The franchisor sought to enforce a non-competition covenant, but gave evidence that it had no intention of opening another franchise in the protected area. The franchisor had no legitimate or proprietary interest to protect.[11]

The Court noted that the non-competition covenant had been reasonable at the time of agreement, but the reasonableness was premised on the understanding that the franchisor would want to continue operating in the area. When the franchisor ceased having the intention to operate, the covenant effectively became unreasonable and unenforceable.

In employment law cases, the courts have routinely struck down non-competition covenants on the grounds that they are too broad, ambiguous or onerous. For example, covenants that purport to restrict competition throughout all of Canada or North America rarely survive the Court's scrutiny.[12] Covenants that restrict trade for an excessive period of time, such as two years or greater, often suffer a similar fate.[13] Non-competition covenants may also be unenforceable where an employer has fallen short of meeting employee obligations under an employment contract. Such is the scenario in the recent case *Powell River Industrial Sheet Metal Contracting Inc v Kramchynski*, where the Court rejected the enforcement of a non-competition covenant as the employer failed to provide the employee with sufficient work. The non-competition covenant was considered illegitimate and exploitative, given that the employer failed to promote the business or address competition, but still sought to restrict the employee from working elsewhere.[14]

In the commercial context, the story is different. The Courts have consistently afforded greater latitude to non-competition covenants negotiated in the context of a commercial transaction as there is no presumption of imbalance in bargaining power. This approach was recently confirmed by the Supreme Court of Canada in *Payette v Guay Inc*.[15] In that case, the appellant entered into non-competition and non-solicitation covenants that restricted his activities in the crane rental industry in Québec for a period of five years. The covenants were executed in favour of the purchaser in connection with the $25-million sale of the appellant's crane rental businesses. Several years later, the appellant's employment with the purchaser was terminated, and he subsequently accepted a position with a direct competitor.

In enforcing the non-competition and non-solicitation covenants, the Court held that such agreements, when executed in connection with the sale of a business, are presumptively lawful unless it can be established by the challenging party that they are unreasonable. In this case, the Court opined that the covenants were a significant consideration granted in return for the $25-million purchase price. It also noted that the geographic scope of the covenants was reasonable in light of the mobility of the crane industry and the broad market served. Therefore, the covenants were upheld.

Even though it is well-established that the enforceability of non-competition and non-solicitation clauses is less restrictive in the commercial context,[16] the covenants still must be reasonable in duration. In *Martin v ConCreate* ("ConCreate"),[17] for example, the applicant entered into non-competition and non-solicitation covenants with the purchaser in conjunction with the sale of two companies. The covenants purported to run for a period of 24 months, commencing after the applicant disposed of his newly-acquired interest in the purchaser. Months after the sale, the applicant's employment with the purchaser was terminated, and he subsequently incorporated a business that allegedly competed with the business of the purchaser.

According to the Court, a "less rigorous test" was to be applied in determining the reasonableness of the covenants because they were made in connection with the sale of a business.[18] Nevertheless, the Court held that the duration of the covenants was indeterminate and therefore unreasonable, with the result that the covenants were unenforceable. In particular, the Court noted that disposition of the applicant's interest in the purchaser required the consent of third party lenders. Since the timing of the consent of the lenders could not be ascertained at the time the transaction occurred and the covenants were drafted, and could be withheld indefinitely, the duration of the covenants was indeterminate. The Court also noted that the scope of the prohibited activities, namely, the concrete business and steel fabrication, was unreasonably broad. The covenants therefore failed.

Non-Solicitation Covenants

Unlike non-competition provisions, non-solicitation covenants permit competition, but more narrowly control the manner of such competition. Typically, they preclude individuals from soliciting business from or through the customers, suppliers, or employees of the party receiving the covenant. Therefore, non-solicitation covenants are generally seen as the "[less] drastic weapon in an employer's arsenal"[19] and usually begin with a greater chance of being enforced than non-competition covenants, at least in the employment context.

Nevertheless, non-solicitation covenants still need to be clear, unambiguous, and reasonable in order to be enforceable.[20] In *Mason v Chem-Trend Limited Partnership* ("Chem-Trend"),[21] for example, the Court was asked to consider the enforceability of non-competition and non-solicitation covenants that prohibited the plaintiff, for a period of one year after employment, from working with or soliciting business from any business entity that was a customer of the employer during the period of the employee's employment.

In striking down *both* covenants, the Court made four observations. First, the parties had also entered into an agreement prohibiting the revelation of trade secrets and confidential information that was sufficient to protect the company's interests. Second, the prohibition against soliciting business from parties who had been customers of the company during the entire period of the employee's employment (17 years) was overly long. Third, the employee did not hold a senior enough position to warrant the level of restriction imposed by the covenants. Fourth, the restriction was not limited to the employee's own customers, but rather to *all* customers of the company (even those with whom the employee never had any contact).

As with non-competition covenants, however, non-solicitation covenants executed in connection with the sale of a business are presumptively lawful, unless it can be established by the challenging party that they are unreasonable.[22] Still, companies must take care not to overreach in the formulation of such covenants, as the courts are apt to strike down those that are unreasonably broad or impractical, even if they are entered into in connection with a commercial transaction, as occurred in the Chem-Trend decision.[23]

A New Approach

In light of the intense scrutiny non-competition and non-solicitation clauses have traditionally faced from the courts, organizations have been increasingly turning to creative and novel contractual tools for protecting their business information and property interests, and recovering costs when an individual engages in activities that compete with the business of the organization.

In a recent decision, *Rhebergen v Creston Veterinary Clinic Ltd* ("Rhebergen"),[24] 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 courts will be more likely to enforce a restrictive covenant that merely inhibits rather than prohibits competition. Organizations 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 an individual engages in competitive activities, the amount prescribed in the clause ought to be based on a clear calculation of objective evidence. In *Rhebergen*, the former 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 organizations from *Rhebergen* is that, when contemplating the inclusion of a compensation clause, the organization ought to base the amount on a best efforts calculation of the anticipated loss connected with an individual competing with the organization.

Intellectual Property Assignment and Licensing Agreements

In any type of commercial transaction where acquisition of intellectual property is contemplated, such as mergers and acquisitions, it is imperative for the purchaser to secure proper transfers of intellectual property rights in order for those rights to be enforceable against third parties and remain valuable assets of the purchaser. Various rights may be identified in that regard, including: copyright, trade-marks, patents and trade secrets.

Copyright

Copyright arises automatically upon creation of a work of authorship. The general rule under Canadian copyright law is that the author is the first owner of the work. An important exception to that rule is for works made in the course of employment, for which the *Copyright Act* deems the employer as the first owner of the work. While a large part of the copyrighted works in a company's portfolio may be created by employees of the company, there can be valuable works created by external consultants or service providers who, in the absence of an agreement to the contrary, retain copyright in the works they create, even where the work was commissioned by the company for valuable consideration.

Therefore, a copyright assignment agreement is necessary in such cases. It is recommended that companies obtain proper transfers of copyright from all authors of a work, including employees. The burden of proving ownership rests with the entity asserting the right, and therefore proper chain of title is critical to asserting and enforcing copyright against third parties.

In order for an assignment or grant of interest in copyright to be valid, it must be in writing and signed by the owner of the right or an authorized agent. Since an exclusive licence in a copyright is deemed by the Copyright Act to constitute a grant of interest, all such licences must be recorded in writing.

Further, the transfer of ownership in a work in which copyright subsists (such as software) does not, in itself, constitute an assignment of the copyright in that work or a waiver of the moral rights of the author. Moral rights include rights of attribution and integrity of the work, and such rights cannot be assigned to a third party but may be expressly waived by the author. An employer cannot waive moral rights on behalf of its employees, even in the case of works made in the course of employment for which the employer is the first owner of copyright. If copyright in those works is assigned as part of a commercial transaction, it is essential that the acquirer of the copyright obtain a waiver of moral rights in its favour.

Trade-marks

Trade-marks can be highly valuable assets of a company, particularly where significant reputation and goodwill has been acquired in the marketplace in connection with a particular brand. Trade-mark rights arise through use of the mark and can be registered or unregistered. Registration confers certain legal advantages, including the exclusive right of the owner to use the mark throughout Canada and the right to restrict use of its mark in a manner that is likely to depreciate the value of the goodwill attaching to it. Unregistered trade-marks are protected by the common law through the tort of passing off, but are limited to the geographical area where goodwill has been established.

If trade-marks are transferred as part of a commercial transaction, care must be taken to acquire not only an assignment of a trade-mark application or registration, but also the goodwill associated with that mark, as significant value may be attached to such goodwill. Additionally, trade-mark owners granting licences (whether exclusive or non-exclusive) in their marks must maintain direct or indirect control over the character or quality of the associated wares or services in order to preserve the distinctiveness of the mark and avoid the risk of losing the mark.

The mere fact that companies are related or one is a wholly-owned subsidiary of the trade-mark owner does not presume that control is exercised over the character or quality of the wares or services in question. Instead, there must be evidence of a licence agreement and evidence of control of the use of the brand by subsidiaries to ensure the character and quality of the wares or services is provided. Further, any assignment involving associated marks or marks which the Canadian Intellectual Property Office ("CIPO") has designated as being confusing with one another, but which are owned or applied for by the same entity, must be assigned concurrently.

Patents

For a company whose mainstay is innovation, patents are critical to protecting the investment into research and development. Therefore, ensuring proper ownership of patents on a company's inventions is critical. Unlike works of authorship made in the course of employment, inventions made by employees, in the absence of a written agreement, are not presumed to be owned by their employers. To establish its patent rights, an employer must therefore satisfy the courts that, among other things, the employee was hired specifically for the purpose of innovating.

In order to avoid ownership disputes, it is essential for companies to have proper written assignments in place with their employees and any contractors, for all intellectual property created by them. This is of particular importance for patents, since assignment of patent rights must be done in writing and accompanied by an affidavit of execution signed by a witness.

Any company acquiring intellectual property must conduct proper due diligence and ensure that all the necessary assignments are in place. Recording of patent assignments with CIPO is also important, as a registered assignment takes precedence over any previous unregistered assignments.

Trade Secrets

Trade secrets or know-how function to give information holders an advantage over their competitors, whether it be commercial, technical, or financial in nature. The pillar of trade secrets is a fiduciary duty of confidentiality owed by the receiver of such information. The importance of trade secrets has been recognized by the courts who have granted protection against misuse or unauthorized disclosure of trade secrets if the information was communicated in confidence and it had the quality of confidence at the time of disclosure. Should trade secrets be shared for commercial or developmental purposes, it is advisable that the holders secure the parameters of their scope and use by contract.

Conclusion

There are numerous legal methods companies can use to protect their proprietary business property in connection with commercial transactions. However, organizations must avoid a "one size fits all" approach. Rather, companies should identify the specific property interests at stake and consider the best method, or combination of methods, necessary to protect those interests.

by Paul Boshyk, Joanna Vatavu, George Waggott, N. David McInnes, and Linda G. Yang

1 *International Corona Resources Ltd v LAC Minerals Ltd*, [1989] 2 SCR 574 (SCC).[ps2id id='1' target=''/]

2 Also see *Coco v A N Clark (Engineers) Ltd*, [1969] RPC 41 (Ch).[ps2id id='2' target=''/]

3 *T Edgar Alberts Ltd v Mountjoy* (1977), 16 OR (2d) 682 (HCJ).[ps2id id='3' target=''/]

4 *Commercial Transport (Northern) Ltd v Watkins* (1983), 22 BLR 249 (Ont HCJ). [ps2id id='4' target=''/]

5 For example, in *The Globe and Mail v CEP* Local 87-M (Ont Arb), unreported decision dated July 3, 2013 (Davie), the arbitrator ordered a former employee to repay settlement monies after she breached the confidentiality provision contained in the minutes of settlement. In that case, the minutes contained a provision expressly stating that the former employee would be required to pay back the settlement monies in the event of a breach of her contractual confidentiality obligations. The employee applied for judicial review of the arbitration award on several grounds in *Jan Wong v The Globe and Mail Inc*, 2014 ONSC 6372, which was wholly unsuccessful).[ps2id id='5' target=''/]

6 *Lyons v Multari*, (2000), 50 OR (3d) (CA).[ps2id id='6' target=''/]

7 A key example of one of those exceptional cases is where the employee is a fiduciary of the employer.[ps2id id='7' target=''/]

8 Elsley v JG *Collins Insurance Agencies Ltd*, [1978] 2 SCR 916 (SCC).[ps2id id='8' target=''/]

9 *Martin v ConCreate*, 2013 ONCA 72.[ps2id id='9' target=''/]

10 *Specialized Property Evaluation Control Services Ltd v Evaluations Marc Bourret Appraisals Inc*, 2016 ABQB 86.[ps2id id='10' target=''/]

11 *MEDIchair LP v DME Medequip Inc*, 2016 ONCA 168.[ps2id id='11' target=''/]

12 *Allen Manufacturing Co v Murphy* (1911), 23 OLR 467 (CA); *Madison Chemical Industries Ltd v Walker* (2000), 4 CCEL (3d) 133 (ONSC). The courts are somewhat more inclined to uphold agreements that restrict competition within a limited geographic area, for example, a 150-kilometer radius of the company's business premises, as in *Spring Fresh Cleaning and Restoration Canada Inc v Campeau*, 2008 ABQB 208. That said, the Courts have also struck down agreements restricting trade within a mere five-kilometer radius, as in Steinke v

Barrett, 2012 MBQB 49. Covenants that effectively create a blanket prohibition of unlimited geographical show are unenforceable, as the employer would likely fail to show why its proprietary interests merit the extraordinary scope of protection, as in *JTT Electronica Ltd v Farmer*, 2014 BCSC 2413.[ps2id id='12' target=''/]

13 *Steinke v Barrett, supra*, note 11. A restriction on trade for a period of six months is somewhat more likely to be upheld, as in *Teleride Sage Ltd v Ventures West Management Inc*, 1996 CanLII 8183 (ONSC).[ps2id id='13' target=''/]

14 *Powell River Industrial Sheet Metal Contracting Inc v Kramchynski*, 2016 BCSC 883.[ps2id id='14' target=''/]

15 *Payette v Guay Inc*, 2013 SCC 45.[ps2id id='15' target=''/]

16 *1059028 Alberta Ltd v Capio Oilfield Services*, 2016 ABQB 234, which followed the SCC's approach in Payette v Guay.[ps2id id='16' target=''/]

17 *Supra*, note 9.[ps2id id='17' target=''/]

18 Also see Shafron v KRG *Insurance Brokers (Western) Inc*, 2009 SCC 6 and *Elsley v JG Collins Insurance Agencies Ltd, supra*, note 8.[ps2id id='18' target=''/]

19 *Lyons v Multari*, supra, note 6.[ps2id id='19' target=''/]

20 *Globex Foreign Exchange Corp v Kelcher* (2011), 205 ACWS (3d) 125 (ABCA).[ps2id id='20' target=''/]

21 *Mason v Chem-Trend Limited Partnership*, 2011 ONCA 344.[ps2id id='21' target=''/]

22 *Supra*, note 12.[ps2id id='22' target=''/]

23 *Supra*, note 17.[ps2id id='23' target=''/]

24 *Rhebergen v Creston Veterinary Clinic Ltd*, 2014 BCCA 97.[ps2id id='24' target=''/]

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.