

February 2009

RESTRICTIVE

Assume that a restrictive covenant, contained in an employment agreement, states that, once the employment is terminated, an employee cannot solicit business for one year from any of the employer's customers doing business in the Greater Toronto Area (the "GTA"). The restrictive covenant seems to be reasonable. It is a non-solicitation, rather than a non-competition, covenant (see October 2008 newsletter); the restricted time is relatively short; and the geographical area is limited. However, is GTA a defined term? If not, is it ambiguous and, therefore, is the covenant containing it unreasonable? If it is, can the employer do anything if the employee starts soliciting its customers in the City of Toronto? Some of these questions are answered in Shafron v. KRG Insurance Brokers (Western) Inc. [2009] S.C.J. No. 6.

Hybrid

The restrictive covenant arose out of a sale of an insurance brokerage. The sale closed at the end of 1987, but the parties did not enter into an employment contract until early 1988. Accordingly, it was not evident whether the agreement resulted from the asset sale or was an ordinary employment contract completed after the closing. Since the sale agreement contained no mention of the restrictive covenant, the courts dealt with the restrictive covenant in the employment context only.

The employment contract was between the purchaser and the individual who sold the brokerage. The parties updated the employment contract over time, but the non-competition

covenant was unchanged. The employment ultimately ended in December 2000. The employee then started working as a salesperson for another brokerage in Richmond B.C., a municipality contiguous to Vancouver to its south. The employer sued the employee claiming that he had breached the non-competition covenant contained in the employment contract. The non-competition covenant stated that:

- a) for 3 years after the employment ended;
- b) the employee could not carry on or be involved with an insurance brokerage;
- c) within the Metropolitan City of Vancouver.

The Court did not refer to the time limitation or the non-competition/non-solicitation dichotomy. The fight related to the geographical area.

Prior Courts

The trial judge held that the restrictive covenant was not enforceable because the geographical area was neither clear, nor certain. The B.C. Court of Appeal applied the doctrine of notional severance and concluded that, although the geographical wording was ambiguous, the Court would define it to cover the City of Vancouver and municipalities contiguous to it. Accordingly, the Court held that the covenant was enforceable. The Supreme Court of Canada had to determine whether the doctrine of severance could be applied to resolve an ambiguity in an employment contract and therefore render reasonable an otherwise unreasonable restriction.

Restraint of Trade

Restraints of trade are, in law, contrary to public policy and therefore unenforceable - unless the restraints are reasonable. It is the common law version of a compromise between public policy and freedom of contract. Reasonableness will depend, in part, on whether the restraint arises out of a sale of goodwill or in the employment context. In the former, the law realises that sales might not take place if vendors can subsequently take away the very goodwill for which the purchasers are paying. In the latter, there is a bargaining inequality and the employee is usually at an economic disadvantage when litigating the reasonableness of a restrictive covenant. Accordingly, the test for reasonableness is far stricter in the employment context.

Since all courts held that "Metropolitan City of Vancouver" was ambiguous (e.g. the trial judge held that was no legal or judicial definition for it), all courts agreed that, unless something more were done, the restrictive covenant would fail (i.e. an ambiguous limitation is, by definition, an unreasonable one).

Blue Pencil Severance

"Under the blue-pencil test, severance is only possible if the judge can strike out, by drawing a line through, the portion of the contract they want to remove, leaving the portions that are not tainted by illegality, without affecting the meaning of the part remaining."

This means that "The courts will only [apply blue pencil severance to] sever the covenant and expunge a part of it if

the obligation that remains can fairly be said to be a sensible and reasonable obligation in itself and such that the parties would unquestionably have agreed to it without varying any other terms of the contract or otherwise changing the bargain. ... It is in that context that reference is made in the cases severing and expunging merely trivial or technical parts of an invalid covenant, which are not part of the main purport of the clause, in order to make it valid."

The Court held that there was no evidence that the parties would have unquestionably agreed to remove the word "Metropolitan" without varying other aspects of the agreement. Indeed, the employer had wanted to include more than just the City of Vancouver. Accordingly, the Court held that blue pencil severance was not appropriate.

Notional Severance

The B.C. Court of Appeal had applied notional severance. *"Notional severance involves reading down an illegal provision in a contract that would be unenforceable in order to make it legal and enforceable."*

As an example, the Supreme Court of Canada has on a prior occasion read down a criminal interest rate to a rate just under the illegal rate, once the Court determined that the parties had not intended to contravene the criminal interest provision. To determine whether to use notional severance, the Court used the bright line test; it held that there was an obvious bright line between legal and illegal (i.e. under or over a 60% interest rate).

The Court held in Shafon that there was no objective bright line between a reasonable and an unreasonable covenant. Further, if the Court engaged in a notional severance, it would invite an employer to impose an

unreasonable restrictive covenant with the only sanction being that a court would enforce it only to the extent of what the parties might have validly agreed to. Accordingly, the Court stated that notional severance could not be used to save restrictive covenants in an employment context.

Rectification

The employer also invited the Court to rectify the agreement. The Court noted that rectification is involved with contracts and documents, not intentions. Accordingly, rectification requires *"(1) the existence and content of the inconsistent prior oral agreement; (2) that the party seeking to uphold the terms of the written agreement knew or ought to have known about the lack of correspondence between the written document and the oral agreement, in circumstances amounting to fraud or the equivalent of fraud; and (3) the precise*

form' in which the written instrument can be made to express the prior intention."

The Court decided that there was no indication that the parties agreed on something and then mistakenly included something else in the contract; rather, they used an ambiguous term drafted by a Toronto lawyer who did not know that "Metropolitan City of Vancouver" was not a legally defined term.

Upshot

The Court found that the restrictive covenant was unenforceable, such that the employee was able to compete anywhere with the purchaser. Would the same situation apply to a reference to the GTA? We do not know. GTA has been used in reports and has a well-known meaning. However, to our knowledge, there is no "official" definition. Out of an abundance of caution, we would refer to the exact municipalities.

Speigel Nichols Fox LLP
30 Eglinton Ave. W., Suite 400
Mississauga, Ontario L5R 3E7
Tel: 905-366-9700
Fax: 905-366-9707
www.ontlaw.com

Jonathan Speigel*+
Brian Nichols
Irving Fox
Ian Latimer*
Robert McIntyre
Susanne Balpataky*
Philip O'Shea*
Paul Roth

* members of commercial litigation group
+ certified by Law Society as a specialist
both in civil litigation & construction law
+ roster mediator – Ontario Mandatory
Mediation program – Toronto

MISSION STATEMENT

**OUR CLIENTS COME
FIRST. EVERYTHING
ELSE FOLLOWS.**

Building Relationships is provided as information to our clients and friends on new developments and legal issues of significance. The information is not intended to provide legal services. Readers should seek professional legal advice on any issues that directly concern them.