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Important Direction on Restrictive Covenants from the Court of Appeal for Ontario

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Restrictive covenants in an employment context are intended to control an individual's competition and conduct in relation to her employer's business after the employment relationship ends. These covenants will only be upheld by the courts if they are reasonable as between the parties and reasonable in light of the broader public interest in discouraging restraints on trade.

In a recent decision, Martin v. ConCreate USL Limited Partnership, the Court of Appeal for Ontario determined that the restrictive covenants included in sale of business agreements were unenforceable because they were drafted more broadly than was necessary to protect legitimate business interests.

This decision highlights three important points for employers: (1) it is important to have a fixed time limit on restrictive covenants; (2) the court will undertake an independent analysis of the reasonableness of restrictive covenants; and (3) overly broad restrictive covenants will be unenforceable and therefore will be unsuccessful in protecting an employer's legitimate business interests. These points are discussed below.

FACTS AND CASE HISTORY

Derek Martin had worked for ConCreate and acquired a minority interest in it, as well as a related business, Steel Design & Fabricators (SDF) Ltd ("SDF"). ConCreate and SDF were sold to entities controlled by TriWest Construction Limited Partnership ("TriWest"). Martin retained his minority interest in ConCreate and SDF. When ConCreate sold its assets to ConCreate USL, an entity controlled by TriWest, Martin obtained 25% of the outstanding limited partnership units of TriWest. As part of the sale and his continued employment, Martin entered into agreements containing restrictive covenants relating to non-competition and non-solicitation, and relating to the use of confidential information.

The non-competition and non-solicitation covenants stipulated that they would end 24 months after Martin disposed of his interest in the partnership units of TriWest. However, he could not dispose of those units without gaining approvals from TriWest's general partner and from the companies and their lenders.

Martin's employment was terminated six months after the sale. He began a competing company eight days later. ConCreate USL and SDF sued Martin, claiming that he had breached the restrictive covenants and his fiduciary duties, and sought damages and injunctions against him. In response, Martin applied for a declaration that the restrictive covenants were unenforceable. The application judge dismissed his application.

The main issue on appeal was whether the non-competition and non-solicitation covenants in the agreements were ambiguous or unreasonable, and therefore unenforceable.

THE COURT OF APPEAL'S DECISION

Writing for the Court, Justice Hoy surveyed the legal framework relating to restrictive covenants, noting that they are *prima facie* unenforceable because they interfere with individual liberty and the exercise of trade. Justice Hoy also noted that restrictive covenants arising in a sale of business context may be necessary to protect the goodwill of the business, and the transaction is typically between two knowledgeable parties of equal bargaining power. Covenants in this context therefore attract a less rigorous test as compared with covenants in a purely employment relationship, but they must still be

reasonable. In determining the reasonableness of a restrictive covenant in either context, courts will consider the same three factors: geographic scope, duration, and the extent of the activity prohibited.

The Court agreed with the application judge that the restrictive covenants were not ambiguous and that their geographic scope was not unreasonable.

However, the Court found that the duration of the restrictions was unreasonable because the duration was for an indeterminate period with no fixed, outside limit. The duration was not calculated from the time of the sale of the businesses or from when Martin ceased acting as an officer or director. Rather, the duration hinged upon Martin's disposition of his partnership units – which was dependent upon the consent of third parties, who were unascertainable at the time the restrictive covenants were agreed to, and owed no duty to Martin to act promptly or reasonably. In that regard, the Court found that the onus was not on Martin to establish that these third parties would not give their consent, as had been suggested by the application judge.

The Court noted that Martin had been represented by legal counsel when he entered into the covenants, had agreed to this provision, and had acknowledged its reasonableness in signing the agreements. However, the Court noted that "while these are important factors, they do not entirely immunize the clause from scrutiny." The Court therefore conducted its own independent analysis of the reasonableness of the restrictive covenants.

Finally, while not determinative of the appeal, the Court found that the scope of the restricted activities in the non-solicitation clause was unreasonable because it applied to business activities that were not carried on or in the parties' contemplation at the time of the sale, or while Martin was involved with the businesses post-sale, or while Martin had an ownership interest in the businesses.

The Court concluded that the non-competition and non-solicitation covenants were unreasonable and therefore unenforceable.

WHAT ARE THE TAKEAWAYS FROM *MARTIN*?

The enforceability of a restrictive covenant is a fact-specific inquiry. Still, we can look to *Martin*, and other previous decisions of the Court, for direction in assessing the enforceability of restrictive covenants included in current employment agreements and for best practices in drafting future covenants.

In light of this recent decision, employers should ensure that restrictive covenants are drafted with a reasonable and *fixed* time limit. Employers should also bear in mind that the court will engage in its own independent analysis of the restrictive covenant to determine if it is reasonable in the circumstances. Finally, and more generally, this case is a good reminder that employers should carefully consider the scope and nature of the restrictive covenants included in their employment agreements. Overly broad restrictions will unnecessarily put an employer's legitimate business interests at risk.

For assistance in reviewing or drafting restrictive covenants to ensure your business interests are protected, please contact Frank Cesario at 416.864.7355, Samantha M. Crumb at 416.864.7327, or your regular Hicks Morley lawyer.

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