FTR Now

The Latest Word on Restrictive Covenants from the Supreme Court of Canada

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The law on restrictive covenants is all about context. Restrictive covenants typically arise in a sale of a business agreement or an employment contract. If you are drafting a restrictive covenant or determining whether a covenant is enforceable, you must be aware of the context because the applicable legal principles vary based on the context. Courts typically apply less scrutiny to restrictive covenants in the sale of business context because, among other things, courts consider that the parties to the agreement will have equal bargaining power, which is not typically the case in the employment context.

In *Payette v. Guay inc.*, the Supreme Court of Canada considered the enforceability of covenants in a sale of business. The Court found the covenants to be reasonable and enforceable, and emphasized the differences between the sale of business and employment contexts. Although the case originates in Québec civil law, the Court's analysis provides helpful guidance on the common law. In this *FTR Now*, we provide an overview of the *Payette* decision.

FACTS

Yannick Payette, and his partner, controlled several crane rental businesses ("Groupe Fortier"). Guay inc., another crane rental company, acquired the assets of Groupe Fortier for $26 million. As part of the purchase and sale agreement, Payette and his partner agreed to stay on as full-time consultants with Guay inc., and reserved the option of subsequently agreeing to a contract of employment.

The purchase and sale agreement included both non-competition and non-solicitation clauses. In brief, the non-competition clause prohibited Payette from having any connection to a business operating in the crane rental industry anywhere in Québec for five years from the date on which he ceased to be employed by Guay inc. The non-solicitation clause prohibited Payette from doing business or attempting to do business with any of Guay inc.'s customers on behalf of a crane rental business or soliciting Guay inc.'s employees for a similar period.

Payette accepted a contract of employment. He was terminated without cause four years later. Payette joined a competitor and seven Guay inc. employees followed soon after. Guay inc. sought to enforce the restrictive covenants.

An initial interlocutory injunction was granted, but the Québec Superior Court later dismissed the action. The Québec Court of Appeal set aside the Superior Court's judgment and ordered a permanent injunction, which required Payette to comply with the terms of the restrictive covenants.

The main issues on appeal to the Supreme Court of Canada were whether Payette was entitled to the protections afforded to employees in the *Civil Code of Québec* (the "*C.C.Q.*"), or in the alternative, whether the non-competition and non-solicitation clauses were reasonable. Art. 2095 of the *C.C.Q.* provides that employers cannot avail themselves of non-competition covenants when they have terminated employees without a "serious reason".

THE SUPREME COURT OF CANADA'S DECISION

WHY THE CONTEXT MATTERS

In the employment context, a non-competition clause is generally *prima facie* unenforceable. It will, however, be enforced if it is reasonable. The party seeking to enforce it must demonstrate that the covenant is reasonable as between the parties, and

the court will also consider whether it is reasonable in the public interest. Although restrictive covenants in the sale of business context have been analyzed with less scrutiny than in the employment context, this principle still appeared to be applicable to covenants in both contexts. [1]

By contrast, the Supreme Court of Canada held in *Payette* that "in the commercial context, a restrictive covenant is lawful unless it can be established on a balance of probabilities that its scope is unreasonable". This appears to represent a change in the law, or at least a clarification, and a potentially important one because it departs from the principle of prima *facie* unenforceability.

SALE OF BUSINESS OR EMPLOYMENT CONTRACT: WHICH RULES APPLY?

The Court endorsed a contextual approach to determine whether restrictive covenants are related to a sale of business or an employment contract. Courts must consider the language of the obligations and the circumstances in which they were agreed upon, to determine the *reason* that the restrictive covenants were entered into by the parties. In this case, the language and circumstances dictated that the covenants were part of the sale of business agreement.

The Court noted that Payette agreed to the covenants as the *vendor* rather than as an *employee*; the agreement provided that he accepted the covenants "[i]n consideration of the sale" without reference to his potential employment status. According to the Court, the reference to the termination of Payette's employment in the covenants was only relevant to determine the start of the restriction period, and did not link the covenants with his employment contract.

The Court also considered that the point of the sale was the acquisition of Groupe Fortier's goodwill, skilled employees and customers; Guay inc. would not have entered into the transaction in the first place if it had not received the protection of the covenants. This established a "direct causal connection between the restrictive covenants and the sale of the assets". Lastly, the subsequent employment contracts made no mention of the restrictive covenants set out in the commercial contract.

As a result, the protections under art. 2095 of the *C.C.Q.* were not available to Payette.

THE REASONABLENESS OF THE RESTRICTIVE COVENANTS

Given that the *C.C.Q.* did not apply, the remaining question was whether the restrictive covenants were reasonable based on the applicable common law principles.

The reasonableness of a non-competition clause is assessed with reference to its duration, geographic scope and the scope of restricted activities. A party seeking to avoid the reach of a restrictive covenant in the commercial context must demonstrate, with reference to these factors, that the restriction in the clause goes beyond what is "necessary for the protection of the legitimate interests of the party in whose favour it was granted". This will depend on several factors relating to the transaction, including the sale price, the nature of the business' activities, the parties' experience and expertise and the parties' access to resources such as legal counsel and other professionals at the time of the negotiations.

In this case, Guay inc. purchased Groupe Fortier for $26 million, after lengthy negotiations between equal parties with the benefit of legal and accounting advice. The Court also considered the "highly specialized nature" of the business' activities and the fact that "cranes are mobile" and that Groupe Fortier did carry on business' activities throughout the province of Québec, although the evidence was that a "vast majority" of the business was carried on only in Montréal. The Court concluded that the duration and geographic scope of the non-competition clause was reasonable.

A non-solicitation clause, on the other hand, does not generally require a geographic scope limitation. As the Court noted, "in the context of the modern economy, and in particular of new technologies, customers are no longer limited geographically, which means that territorial limitations in non-solicitation clauses have generally become obsolete." As such, despite the absence of a territorial limitation, the Court concluded that the non-solicitation clause was also reasonable and enforceable.

TAKEAWAYS FROM *PAYETTE*?

The enforceability of a restrictive covenant will always be a fact-specific inquiry, highly dependent upon the context in which it arises. The Supreme Court of Canada's decision in *Payette* emphasizes the importance of determining whether a restrictive covenant is an *employment* obligation or a *commercial* obligation.

If you are negotiating a sale of business agreement which provides for employment, or the possibility of employment, of the vendor you should carefully consider the purpose of any restrictive covenants and ensure to tie those obligations to the proper agreement (i.e. commercial or employment). Likewise, if an employer is assessing a restrictive covenant in the context of hiring an employee, it is crucial to know the context in which that covenant arose.

If you require further information about this decision, please contact Frank Cesario at 416.864.7355, Samantha M. Crumb at 416.864.7327 or Sean M. Sells at 416.864.7274, or your regular Hicks Morley lawyer.

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[1] *Martin v. ConCreate USL Limited Partnership*, 2013 ONCA 72 (CanLII) at paras. 49-54. For a discussion of this case, see our *FTR Now* of February 6, 2013, "Important Direction on Restrictive Covenants from the Court of Appeal for Ontario".