Case In Point

Appellate Court Finds Restrictive Covenant Not Enforceable Where Party Had No Legitimate/Proprietary Interest to Protect in Territory

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The Ontario Court of Appeal recently found that a restrictive covenant was unreasonable because the respondent, who sought to enforce the covenant, did not have a legitimate or proprietary interest to protect within the territorial scope of the covenant. In MEDIchair LP v. DME Medequip Inc., the Court was asked to decide whether the application judge had erred in finding that the restrictive covenant (provided in the course of a sale of business) was reasonable in scope, having regard to the legitimate or proprietary interest of the respondent.The Court began its analysis by reviewing the principles of reasonableness which govern the enforceability of restrictive covenants in Canada. Citing the Supreme Court of Canada in *Payette v. Guay*, the Court noted:

[38] […] the test for reasonableness is whether the clause is "limited, as to its term and to the territory and activities to which it applies, to whatever is necessary for the protection of the legitimate interests of the party in whose favour it was granted."…

[40] […] "A non-competition clause that applies outside the territory in which the business operates is contrary to public order." […]

Using these principles, the Court of Appeal overturned the application judge's decision and concluded that while the covenant was unambiguous and the temporal and territorial boundaries were not too broad, the covenant was still unreasonable because the respondent did not have a legitimate and proprietary interest to protect in the territorial region.

In reaching its conclusion, the Court relied heavily on the admissions made by the respondent in cross-examination, namely that they had no plans to set up a franchise in the restricted territory and hadn't since the covenant had been signed.

Although the Court acknowledged the different levels of scrutiny that will apply when assessing a covenant, based on whether it is given in the employment context or a sale of business, it concluded that it did not need to decide what level of scrutiny properly applied. The focus of the inquiry was not the reasonableness of the temporal and territorial restrictions; instead it was whether there was a legitimate interest entitling protection which applies regardless of the level of scrutiny used.

The Court also observed that while reasonableness will be interpreted on the parties' anticipated expansion of the business at the time the covenant was signed, the covenant will not be enforced where such anticipated business expansion does not come to fruition. In other words, although the parties may have acknowledged at the time they signed the covenant that the respondent had an interest to protect in the territorial region cited (based on its expansion plans) the respondent was not entitled to rely on this interest when seeking to enforce the covenant if such expansion never occurred.

This case serves as a good reminder that even though a covenant may be reasonable in respect of time and space, the party seeking to rely on the covenant must still show that the covenant is necessary to protect a proprietary interest within the defined geographic scope. It also suggests that while reasonableness of a covenant continues to be assessed based on the reasonable expectations of the parties at the time it was signed, enforcement of the covenant will likely depend on the commercial realities which exist at the time of enforcement.

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