

PLANNING FOR (NON) COMPETITION

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How would your business fare if one of your key employees left and set up shop across the street? How much would a buyer pay for your company if you could start running the same type of business next door?

A non-competition covenant can be a valuable tool to protect a business interest whether you are protecting an existing business or selling one. Non-competition clauses are commonly included in employment contracts, sale agreements and shareholder agreements.

Your departing employees could use confidential or proprietary information for their own benefit, solicit your clients or customers, or directly compete with your business. To avoid this, you should have a non-competition covenant included in your employment contract. Similarly, if you are selling a business, you can increase the value to prospective purchasers by offering to include a non-competition covenant in the sales agreement prohibiting you from engaging in the same kind of business.

The value of these clauses seems obvious and many business people seek to include them in their employment and sales contracts. A well drafted non-competition covenant may mean the difference between the success or failure of a business. The difficulty with these covenants comes in their enforceability. The clauses receive significant judicial scrutiny and there is a substantial risk that such covenants will not be enforced.

Canadian courts have shown a reluctance to enforce non-competition covenants. The underlying reason is usually that the clauses are contrary to public policy. The business environment is one where competition should be and is generally encouraged. Any scenario that limits competition is going to be judged very critically. In fact, a court that is asked to enforce the terms of a non-competition clause will start with the presumption that all covenants restraining trade are illegal and unenforceable. It is up to the party trying to enforce the clause to overcome this.

The presumption that the clause is illegal can be rebutted. Courts will uphold and enforce the covenant, provided it was reasonably necessary to protect a legitimate proprietary interest and the covenant goes no further than necessary to protect that interest.

Courts are more prepared to enforce non-competition clauses in an agreement for the sale of a business than in an employment contract. The reason for this difference lies in the bargaining power of each of the parties in the different circumstances. An employee, in most instances, has a very limited ability to affect the terms of her employment contract. She must either accept the terms or find other employment. Further, such clauses could prevent an employee from bettering her position, because she is restricted from obtaining similar employment elsewhere. The party truly benefiting from the inclusion of the clause in the contract is the employer. With the sale of a business, on the other hand, the seller may not have the ability to sell her business if she does not provide a non-competition clause. Conversely, the buyer may not be interested in purchasing the business if the seller can start a new business next door. In the case of a sales agreement there is an obvious benefit to both the buyer and the seller to have a non-competition clause included.

Careful wording of any non-competition clause is crucial. The drafter must have a good

understanding of the interest being protected, and must use terms which impose the least restriction while still protecting that interest. First, the non-competition clause must be directed at protecting a legitimate proprietary interest. In the case of an employment relationship, a legitimate proprietary interest could include the trade secrets, confidential information and trade connections of the employer. Included in the trade connections would be the goodwill and relationship established between the employee and the employer's customers or clients. In a purchase and sale transaction, the purchaser may be seeking to protect all of these things, but most likely the focus will be on protecting the goodwill associated with the business.

The non-competition covenant must go no further than is reasonably adequate to give the required protection. In determining whether a clause goes beyond what is reasonably adequate the courts will look closely at the activities sought to be restricted, the geographic area of restrictions and the duration of the restriction. If the covenant is too wide as to time, place or scope it will not be enforced.

If it is determined that the clause is too broad, the Court will not simply read the clause down or limit its application. The clause will be *totally* unenforceable, and the individual who may have been seeking to protect a legitimate proprietary interest will have no protection at all. It comes back to careful drafting of the non-competition clause in the first instance – the clause must not overreach, but it must be broad enough to protect the legitimate proprietary interest.

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