Executive Employment

a journal devoted to employment and related contract, dismissal and liability issues

Volume VIII, No. 2 2001

Highlights

EMPLOYMENT CONTRACTS

the need for non-competition clauses

Why do employers need non-competition and non-solicitation clauses? How should such covenants be drafted, to be enforceable? For many rank and file information workers, the employer may be less concerned with limiting competition than with protecting information an employee obtains in the course of employment. In this context, a confidentiality/non-disclosure clause may be sufficient. However, for management and more strategic employees, both confidentiality/non-disclosure and non-competition clauses are essential. Eric Durnford and Shona Lake-Crossley assess recent cases dealing with the legitimate business interests protected by restrictive covenants, as well as the implications of failing to include carefully drafted non-competition and non-disclosure clauses in employment contracts. 426

NON-COMPETITION COVENANTS

freedom of contract versus public interest

Employment contracts often contain covenants restricting an employee's post-employment conduct. In seeking to strike a balance between freedom of contract and free competition, Ontario's Court of Appeal recently weighed heavily in favour of the latter, in applying the common law's aversion to restraints on trade. As Joe Conforti explains, in his analysis of *Lyons v. Multari*, a high hurdle has been established, at least in Ontario, for those seeking to enforce non-competition covenants. Such covenants will be enforceable in only "exceptional cases." 430

EMPLOYEE BENEFITS

the exercise of discretion in benefit plans

Some benefit plans for senior managers and executives contain provisions which make the award of the benefits under the plan subject to the discretion of the employer, usually the compensation committee of the Board. Employers may want to exercise that discretion to restrict the payment of a benefit to a departing employee. However, depending upon the circumstances, courts will find that the employer does not have an unlimited discretion and the exercise of the employer's discretion must be consistent with other contractual obligations and the intentions of the parties. Bruce Grist reviews *Petty v. Telus Corporation*, a recent decision of the B.C. Supreme Court which is an example of how an employer's discretion in the provision of benefits may be limited. 436

Federated Press

NON-COMPETITION COVENANTS

Freedom of Contract Versus the Public Interest

Joe Conforti
Goodmans LLP

Introduction

Confidential business information and client relationships are key assets of any business. The continued success of a business is contingent on its ability to protect these assets, especially in times of widespread employee turnover.

Employment contracts often contain covenants restricting an employee's post-employment conduct, including: non-competition (preventing the departing employee from competing with the employer either by joining the competition or by establishing a competing business); non-solicitation (preventing the employee from soliciting the employer's clients); and confidentiality (protecting from disclosure all proprietary or confidential information and trade secrets before and after termination of employment).

Although an employment relationship is a commercial contract at its essence, when a valued employee departs to join or to start a competing business, a myriad of competing interests come into play:

- public interest in free competition in the marketplace;
- the legal interest in upholding freely negotiated contracts;
- clients' interests in more favourable trade terms;
- the former employer's interest in protecting valuable assets;
- the departing employee's interest in pursuing his or her chosen livelihood in the manner the employee sees fit; and
- the new employer's interest in enhancing his own business opportunities without being drawn into costly litigation.

In a recent decision, *Lyons v. Multari,*[1] the Ontario Court of Appeal was faced with the enforceability of a non-competition covenant in the context of a departing professional. The Court framed the issue starkly at page 527:

> This appeal calls for striking a proper balance, in a professional employment context, between competing values – on the one side, the sanctity of a clear contract between equals, set against, on the other side, the law's long-standing aversion to contracts that attempt to restrict competition generally.

The Court of Appeal's decision and its supporting rationale will have significant impact on the nature of the employer/employee relationship, concerning both negotiation of employment contracts (for newly hired employees) and available remedies upon their departure.

Facts

In the spring of 1993, Dr. Multari, a dentist, completed his specialization training in oral surgery at Dalhousie University in Halifax, Nova Scotia. For family and professional reasons, he decided he wanted to practice his profession in Windsor, Ontario. At the same time, Dr. Lyons, who had practiced oral surgery in Windsor for almost 25 years, was looking for a new associate dentist. Dr. Lyons and Dr. Multari met and following relatively short negotiations, they agreed to work together. Dr. Lyons continued as the principal dentist in his practice, with Dr. Multari becoming his associate.

On June 17, 1993, the two dentists signed a short handwritten contract of less than a page. There were only three provisions in the contract. The first provision dealt with Dr. Multari's remuneration and the third provision required Dr. Multari to give six months' notice if he decided to leave Dr. Lyons' practice; these provisions were complied with. The second provision was a non-competition covenant that restricted where Dr. Multari could practice if he left Dr. Lyons' office. The entirety of the non-competition covenant read: "Protective Covenant. 3 yrs. – 5 mi."

Dr. Multari worked with Dr. Lyons for about 17 months. In January 1995, Dr. Multari gave the required six months' notice of

[1] (2000), 50 O.R. (3d) 526 (C.A.).

resignation. Dr. Multari left after the six months was up and began to work part-time in a dental office located more than five miles from Dr. Lyons' office. Six months later, in January 1996, Dr. Multari opened an oral surgery practice in Windsor in competition with Dr. Lyons' oral surgery practice. There was no dispute that Dr. Multari's new practice was commenced within six months of leaving Dr. Lyons' practice and his office was located only 3.7 miles from Dr. Lyons' office. In short, Dr. Multari breached the non-competition covenant.

Dr. Lyons commenced a lawsuit against Dr. Multari, seeking damages for breach of contract.

Trial Judgment

After a five day trial, the Trial Judge upheld the non-competition covenant, found Dr. Multari in breach of contract, and awarded damages of over $70,000 against him in favour of Dr. Lyons.

The Trial Judge rejected Dr. Multari's position that he did not understand what the non-competition covenant meant when he signed it. The Trial Judge described the written contract as "elegant in its simplicity," finding that the non-competition covenant was "intended and was understood by Lyons as drafter and Multari as signatory to be a clause restricting the potential opening by Multari within three years of termination at any office located within five miles of the Lyons office."

The Trial Judge then considered whether the non-competition covenant was enforceable. He recognized that it would be enforceable only if Dr. Lyon had a proprietary interest worthy of legal protection. The Trial Judge stated that the nature of Dr. Lyons' dental practice was a referral practice; that is, his specialized dental practice was largely dependant on patient referrals from other dentists. Of necessity, therefore, over a long period of time of practice in Windsor, Dr. Lyons had developed a group of dentists who customarily made referrals to his practice. The Trial Judge concluded that this qualified as a proprietary interest capable of legal protection – whether this interest was called "goodwill," "custom" or "business association."

The Trial Judge then considered whether the three year/five mile ambit of the non-competition covenant was too geographically or temporally broad or too restrictive of competition in general. The Trial Judge concluded that the non-competition covenant was valid since Dr. Multari could practice in significant portions of Windsor and Dr. Multari could even seek referrals from within the five mile restricted area so long as his office was not physically located within that zone. Finally, the Trial Judge determined that there was no evidence that demonstrated that the non-competition clause would entirely preclude Dr. Multari from engaging in the practice of oral surgery such as to deny to the public generally access to his expertise and services.

As a result, the Trial Judge concluded that the non-competition covenant was enforceable.

Court of Appeal

Dr. Multari appealed the Trial Judge's decision. Dr. Multari did not assert that the Trial Judge erred in finding the non-competition covenant was clear on its face and that Dr. Multari understood its meaning and effect. His appeal was limited to whether the non-competition covenant was valid and enforceable. (There was also an appeal and cross-appeal on damages issues, which will not be considered for the purposes of this article).

In this regard, the Court of Appeal was faced with two essential issues:

1. Did Dr. Lyons have a proprietary interest in the dentists who referred patients to his specialized oral surgery practice?
2. Was the non-competition covenant at issue overbroad and did it restrict competition in general?

The Court of Appeal in Lyons applied long-standing Canadian legal principles. As a general proposition of law, any departing employee has the absolute right to go immediately into direct competition with his former employer and to make use of all skills, general knowledge and personal goodwill acquired during the course of his employment.[2] As a corollary, the general rule is that a non-

[2] *Edgar T. Alberts Ltd. v. Mountjoy* (1977), 16 O.R. (2d) 682 (H.C.), at 686; *R.W. Hamilton Ltd. v. Aeroquip Corp.* (1988), 65 O.R. (2d) 345 (H.C.), at 352; *Re Berkey Photo (Canada) Ltd. v. Ohlig* (1983), 43 O.R. (2d) 518 (H.C.), at 531-535; *309925 Ontario Ltd. v. Tyrrell* (1981), 127 D.L.R. (3d) 99 (Ont. H.C.), at 107.

competition covenant in an employment contract is void as an unlawful restraint of trade.[3]

However, this general rule of unenforceability does have exceptions. A restraint of trade may be valid provided that it is reasonable in the interests of the contracting parties and also reasonable in the public interest. The Court of Appeal recognized that there was a collision between the twin objectives of respecting freedom of contract and of discouraging restraints of trade:

> The principles to be applied in considering restrictive covenants of employment are well-established .... A covenant in restraint of trade is enforceable only if it is reasonable between the parties and with reference to the public interest. As in many of the cases which come before the courts, competing demands must be weighed. There is an important public interest in discouraging restraints on trade, and maintaining free and open competition unencumbered by the fetters of restrictive covenants. On the other hand, the courts have been disinclined to restrict the right to contract, particularly when that right has been exercised by knowledgeable persons of equal bargaining power.[4]

According to the *Lyons v. Multari* decision, there is a three-fold test to be applied in considering any restrictions in an employment contract. First, does the employer have a proprietary interest entitled to protection? Second, are the temporal or spatial features of the contract too broad? Third, is the covenant unenforceable as being against competition generally and not limited to proscribing solicitation of clients?[5]

The Court of Appeal analyzed these factors in *Lyons v. Multari* as follows:

Proprietary Interest

Because the group of referring dentists changed over time, Dr. Multari asserted that Dr. Lyons had no proprietary interest in the dentists who referred patients to his specialized oral surgery practice.

The Court of Appeal disagreed and held that Dr. Lyons did have a proprietary interest in at least some some of his referring dentists. Well-established case law supports the proposition that employers have a proprietary interest in their client base.[6] Moreover, Dr. Lyons' practice was one in which long years of service in Windsor resulted in a core group of dentists who, by custom, made referrals to him. These customary referrals are "goodwill," qualifying as a proprietary interest capable of legal protection.[7]

Temporal and Spatial Limits

The Court of Appeal concluded that a three year/five mile restriction is reasonable for professionals. In support, the Court cited the Supreme Court of Canada's approval (in its 1978 decision, *Elsley v. J.G. Collins*) of a five-year restriction extending over three communities.[8]

Non-Competition Versus Non-Solicitation

In the view of the Court of Appeal, non-solicitation covenants in an employment contract are "quite common." In contrast, a non-competition covenant "is a more drastic weapon in an employer's arsenal. Its focus is much broader than an attempt to protect the employer's client or customer base; it extends to an attempt to keep the former employee out of the business."[9]

The Court of Appeal determined that, in general, a non-competition covenant ought not to be enforced if a non-solicitation covenant would adequately protect the employer's interests. The Court of Appeal quoted favourably from the *Elsley v. J.G. Collins* decision:

> The next and crucial question is whether the covenant is unenforceable as being against competition generally, and not limited to proscribing solicitation of clients of the former employer. ... Whether a [non-competition] restriction is reasonably required for the protection of the covenantee can only be decided by considering the nature of the

---

[3] *Nordenfelt v. Maxim Nordenfelt Guns & Ammunition Co. Ltd.*, [1894] A.C. 535 (H.L.), at 565.

[4] Quoting *Elsley v. J.G. Collins Insurance Agencies Ltd.*, [1978], 2 S.C.R. 916, at 923.

[5] Ibid. at 925; *Lyons v. Multari*, supra note 1 at 532.

[6] *Gordon v. Ferguson* (1961), 30 D.L.R. (2d) 420 (N.S.S.C.); *Friesen v. McKague* (1992), 96 D.L.R. (4th) 341 (Man. C.A.); *Simioni v. Sugarman*, [2000] N.J. No. 28 (Nfld. S.C.T.D.).

[7] Supra note 1 at 532-33.

[8] Ibid. at 533.

[9] Ibid. at 533-34.

> covenantee's business and the nature and character of the employment. Admittedly, an employer could not have a proprietary interest in people who were not actual or potential customers. Nevertheless, *in exceptional cases*, of which I think this is one, the nature of the employment may justify a covenant prohibiting an employee not only from soliciting customers, but also from establishing his own business or working for others so as to be likely to appropriate the employer's trade connection through his acquaintance with the employer's customers. This may indeed be the only effective covenant to protect the proprietary interest of the employer. A simple non-solicitation clause would not suffice.[10] [emphasis added]

The Court of Appeal then assessed whether the employment/professional relationship between Dr. Lyons and Dr. Multari was one of those "exceptional cases" where "a simple non-solicitation clause would not suffice."

There were factors which favoured enforcement of the broad non-competition covenant. This included the fact that the relationship between Dr. Lyons and Dr. Multari "was one between equals." There was no disparity of bargaining power. Although Dr. Lyons had practiced oral surgery in Windsor for almost 25 years, the reality was that Dr. Multari was "a highly educated man with many employment options open to him." Further, Dr. Lyons treated Dr. Multari well during their association, introducing him to his referring dentists, encouraging referrals to Dr. Multari, assisting in his obtaining hospital privileges, etc. All of this meant that, as Dr. Multari started his career, he had a steady flow of patients and substantial income (approximately $200,000 annually).

Notwithstanding these factors, the Court of Appeal concluded that the non-competition covenant did not come within the category of "exceptional cases." This conclusion was based on the following:

- Although Dr. Lyons had proprietary interest in some regular referring dentists, he had no proprietary interest in Windsor dentists who had never referred patients to him in the past or who had stopped referring patients to him before Dr. Multari's arrival. There could be no proprietary interest in people who were not actual or potential customers.[11]
- Although Dr. Multari was treated well during the professional association, Dr. Lyons also benefited as well through a fee-sharing arrangement.
- Dr. Multari's role in the oral surgery practice was that of a "normal associate." Dr. Multari was not the one who managed the practice, nor was he the "front man or principal contact person" for dealing with the referring dentists, nor was he the "personification" of the business. Rather, Dr. Lyons always remained the "dominant figure"; Dr. Multari simply handled the patients who were referred to him. Put another way, Dr. Multari was not a "fiduciary" but a mere employee. This conclusion is reinforced by the fact that Dr. Multari was a junior associate who worked for less than two years with Dr. Lyons.
- The broad non-competition covenant could not be enforced on the basis that it was required to protect confidential information. Dr. Multari took no trade secrets or confidential information on his departure. He never saw a list of Dr. Lyons' patients or referring dentists. Although Dr. Multari did know, of course, the names of the referring dentists of patients he had personally treated, a simple non-solicitation covenant would have prevented him from soliciting those dentists.
- The evidentiary record disclosed that non-competition covenants were not universally used in local dentistry practices. On the contrary, the available evidence suggested that non-solicitation covenants were more prevalent.

After balancing all of the factors, the Court of Appeal concluded that the non-competition covenant was unenforceable. The legitimate interest Dr. Lyons had in protecting his own referring dentists and patients could (and should) have been protected by a non-solicitation covenant:

[10] Supra note 4 at 926.

[11] Ibid. at. 926.

> An established professional person or firm – be it in the field of dentistry, medicine, engineering, architecture, law or other professions – will constantly seek to recruit entry-level associates to the practice. Such recruitment is good for the established person or firm and for the young associate.
>
> It is natural that many of these relationships will end after a few years. Sometimes the firm will terminate the relationship; in other cases the associate will decide to move on. For professional and personal reasons, many associates will want to continue to work in the same community after they have left the original employer. There is nothing wrong with such a preference. However, the employer has a legitimate interest to protect – namely, its clients. In my view, in the circumstances of this case, a proper balancing of the interests of the employer and the departing employee is struck by the line drawn in *Elsley*. As a general rule, non-solicitation clauses are permissible, in "exceptional cases," only non-competition clauses will be upheld.
>
> In my view, this is not an exceptional case. Indeed, the Lyons-Multari relationship strikes me as the norm in a professional setting. Accordingly, the non-competition covenant is unenforceable.[12]

As a result, the Court of Appeal reversed the Trial Judge's decision and found that the non-competition covenant was not enforceable. Dr. Multari was, therefore, not in breach of contract and not liable for damages.

As an ironic side-note, the effect of the Court of Appeal's decision seems to have left Dr. Lyons with no protection – contractual or otherwise – over his clients/referral source. The non-competition covenant was struck down because the legitimate business interests could have been protected by a non-solicitation covenant; however, there was, in fact, no non-solicitation covenant (presumably because Dr. Lyons was relying on the non-competition covenant).

Conclusion

The ultimate disposition in *Lyons v. Multari* and the Court of Appeal's determination that the non-competition covenant was unenforceable is not surprising on the facts of that case. The significance lies in the underlying rationale. The Court of Appeal could have, but did not, strike the non-competition covenant for a number of other reasons:

- The temporal restriction is significantly longer than permitted by recent case law (which would suggest, typically, 12 months or, at the outside, 18 months, as an adequate period of non-competition).[13]
- Professionals such as physicians and lawyers have overriding fiduciary obligations to their clients which is higher than any duties owed to their employers. As such, there is a public interest and professional/ethical responsibility in maintaining a free choice of professional services to clients.[14]
- The public may be adversely affected by having fewer necessary services available to it in the relevant marketplace; this is especially true of medical services. For example, in an earlier case, a Court refused to enforce a restrictive covenant signed by an obstetrician who had agreed that he would not practise any form of medicine or surgery for five years within five miles of St. Catharines. The Court determined that, due to public interest considerations flowing from there being a shortage of obstetricians in the relevant geographic area, the covenant was unenforceable.[15]
- The wording of the purported non-competition covenant itself leaves much to be interpreted and, arguably, did not constitute a "meeting of the minds." (Note: this point seems to have been precluded by the Trial Judge's finding of fact). The Court could have interpreted the covenant against Dr. Lyons or "read down" the prohibited restrictions so as to permit most, if not all of, Dr. Multari's post-employment activities.

[12] *Lyons v. Multari*, supra note 1 at 536-37.

[13] See e.g., Levitt, *The Law of Dismissal in Canada* (2d Ed.), at 444.

[14] *Goodman v. Newman* (1986), 13 C.P.R. (3rd) 48 (Ont. H.C.); *Vertlieb Anderson v. Nelson*, [1990] 2 W.W.R. 58 (B.C. Co. Ct.) reversed on other grounds [1992] 5 W.W.R. 97 (C.A.).

[15] *Sherk v. Horwitz* (1972), 25 D.L.R. (3d) 675 (Ont. H.C.).

Does the Court of Appeal's failure to deal with the above factors mean they are not valid? This is unlikely, but development of the cases after *Lyons v. Multari* will have to be monitored.

The Court of Appeal framed the issue in *Lyons v. Multari* as a balancing between the freedom of contract versus the public interest in free competition/discouraging restraint of trade. In the final result, the Court weighed heavily in favour of free competition and an extremely high hurdle will have to be met for any non-competition contract to be enforceable. The presumption is that, at least for professionals, free movement is of societal benefit and is to be encouraged.

This parallels recent judicial confirmation of the importance of the right to work and in maintaining an individual's livelihood. The central societal importance of the status of being an employee was recently confirmed by the Supreme Court of Canada:

> Work is one of the most fundamental aspect of a person's life, providing the individual with a means of financial support and, as important, a contributory role in society. A person's employment is an essential component of his or her sense of identity, self worth and emotional well-being.[16]

In this way, personal autonomy is merged with the "public interest." Put in this context, the Court of Appeal's balancing is not at all unforeseeable.

Notice for leave to appeal to the Supreme Court of Canada has been filed. Pending that determination (if any), employment contracts should be reviewed very carefully by employers and employees. Restrictive covenants should never be "boilerplate"; rather, they should be adapted to the specific position, responsibilities and client contact of the particular employee. If a non-solicitation and/or confidentiality covenant can suffice, that should be the employer's sole protection. Barring "exceptional" circumstances, any non-competition covenant will be unenforceable.

Employment contracts should be fair, reasonable, drafted so as to protect only those interests that the employer absolutely required. Contrary to an employer's (or its lawyers') first instincts, the objective is not to negotiate for as much as possible, since this may ultimately be unenforceable and counter-productive. A covenant providing the minimum protection legitimately required will have the maximum likelihood of enforceability.

---

[16] *Machtinger v. HOJ Industries Ltd.* (1992), 91 D.L.R. (4th) (S.C.C.), at 507 (quoting *Reference re Public Service Employee Relations Act*, [1987] 1 S.C.R. 313, at 368).