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Blaney McMurtry
BARRISTERS & SOLICITORS LLP

Blaneys on Business

This newsletter is designed to bring news of changes to the law, new law, interesting deals and other matters of interest to our commercial clients and friends. We hope you will find it interesting, and welcome your comments.

Feel free to contact any of the lawyers who wrote or are quoted in these articles for more information, or call the head of our Corporate/Commercial group, Alex Mesbur at 416.593.3949 or amesbur@blaney.com.

RESTRICTIVE COVENANTS IN EMPLOYMENT CONTRACTS MUST BE DRAFTED CAREFULLY TO BE ENFORCEABLE

Mark E. Geiger

In the ebb and flow of business news in the last two quarters, one of the most interesting stories out there has involved the extra $11.5 million that had to be paid to Motorola so that a recently-departed executive could assume new duties as CEO of Nortel Networks.

The payment was required because the executive's employment contract with Motorola included a clause that prohibited him from working for a competitor for a time after leaving Motorola.

This kind of "non-compete" clause, and such other restrictive covenants as non-disclosure clauses and non-solicitation clauses, are relatively common in employment contracts and in some other commercial contracts involving employment.

Enforcing them successfully, however, as Motorola was able to do, can be another matter. In that context, it is crucial that restrictive covenants be drafted with great care and expert knowledge of employment case law.

Restrictive covenants are often used to protect a business against exploitation by employees, ex-employees, shareholders or previous owners.

Confidential information about the business, trade secrets or familiarity and/or relations with suppliers or clients can give these individuals a tremendous competitive advantage. For this reason restrictive covenants are often included in the employment contracts of senior managers, professionals, or technical and sales employees. They are also common in shareholder agreements and agreements of purchase and sale. Often they relate not only to the period when the individual is actually employed or holds shares, but also to a period after the relationship ends.

The law with respect to restrictive covenants is easier to state in principle than to apply in particular situations. The difficulty arises because restrictive covenants, by their very nature, are a restraint of trade. As such, they create conflict between two or more competing legal principles. First, parties normally have the freedom to contract, including the right to restrict their own rights, especially if they are being compensated for so doing. However, society's economic interests can be impaired by restrictive covenants that either prevent or impede peoples' ability to work or that reduce competition. Historically, all restraints on the freedom of an employee to work at his trade or profession have been deemed illegal by the courts because they restrained trade. However, the law has developed to allow enforcement of restrictive covenants so long as they meet the following general criteria:

1. The business attempting to enforce the clause has a legitimate "proprietary interest" which is deserving of protection.
2. The restrictive covenant must be reasonable, both with respect to its duration and its geographical coverage. Both of these categories are tested in conjunction with the proprietary interest which the court has found appropriate.
3. The restrictive covenant must be, on balance, "fair" to both parties.
4. The restrictive covenant is not otherwise contrary to the public interest.

Although the principals are easy to state, they are not so easy to apply to particular circumstances. The first question that needs to be examined is the nature of the restrictive

"Courts have long recognized the dominant bargaining power of the employer in employment contracts. For this reason, the 'fairness' criterion takes on considerable importance in these cases."

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covenant itself. The three main types of restrictive covenants are non-disclosure, non-solicitation and non-competition.

Non-Disclosure

Non-disclosure clauses are intended to protect what is essentially a property right. Your business plans, trade secrets, customer lists and other confidential information are the 'property' of your business. Clauses that protect this 'property' are usually enforceable unless they attempt to protect information that is really in the public domain. So, you cannot stop an employee from using the skills he has acquired while he has worked for you, but you can stop him from disclosing customer lists or other confidential business information that is your property.

Non-Solicitation

Non-solicitation clauses are more restrictive because they potentially affect others. Departing senior sales agents can create huge problems for businesses when they leave to work for direct competitors. Without a restrictive covenant they are free to attempt to sell similar services from their new employers to the customers they serviced for you. A non-solicitation provision in their contract can prevent them from doing this. In most cases a clause that restricts an ex-employee or shareholder from soliciting business from the very customers they serviced for you will be enforceable unless the customer list you are trying to protect is too all encompassing. However, this type of provision will not prevent your customers from seeking out the departed employees after they have left. Therefore many businesses want the added protection of a non-compete clause.

Non-Compete

Non-compete provisions are the most restrictive covenants and therefore the hardest to enforce. By their very nature they attempt to prevent an individual from competing with you and are therefore clearly an attempt to restrain trade. Historically they were simply unenforceable. That is no longer the case. To be enforceable, however, they must satisfy the criteria set out above.

If the non-compete clause is part of a corporate transaction such as a sale, and if it is an essential element of the sale, courts will normally enforce it. Similar considerations apply to shareholder agreements for similar reasons. However, where the non-compete is part of an employment contract, great care must be taken to insure that the criteria are met. Courts have long recognized the dominant bargaining power of the employer in employment contracts. For this reason, the 'fairness' criterion takes on considerable importance in these cases. It is crucial to remember that the particular facts of the situation are all important. What the employee actually does, what the business is, where the business is conducted and what the clause says will always be examined in detail. Importing a clause designed for another situation or using 'standard boiler plate language' is almost always a bad idea.

While it is impossible to give specific rules as to what will or will not be enforceable, some guidance can be deduced from the decided cases. Here are some questions that may help:

1. Has the employee been provided with sufficient compensation to justify the restriction? Employees who are terminated for other than cause are required to be given "reasonable notice" pursuant to the common law. Where the period of notice coincides with the period under which they are prevented from competing, a court will have little difficulty finding that the employee has been fairly remunerated for agreeing to the restrictive covenant. However, where employers attempt to reduce their contractual obligations to provide reasonable notice under the contract, and yet seek to prevent the

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employee from competing against them, the courts will be less likely to enforce. If the clause effectively prevents the employee from working at his trade or profession for any period beyond the period of notice given, it will generally not be enforceable.

2. Is the duration of the restriction reasonable? As outlined above, the duration of the restrictive covenant is often related to the period of notice the employee is given. Where that period is significantly less than the duration of the restrictive covenant, it will be more difficult to establish the reasonableness of the clause. In most cases, durations of greater than two years are problematic. The shorter the duration of the non-compete, the more likely it is to be enforceable.

3. Could the legitimate interests of the employer be met by specifically naming customers or clients to whom the non-compete would apply? Courts are less reluctant to enforce non-competition clauses where specific lists of customers are sufficient to protect the employer's interests. If a specific list is not realistic, would a blanket clause prohibiting the solicitation of existing customers of the company suffice to protect the employer's interest? Where that list might be too lengthy, it could be narrowed to just that list of customers with whom the employee in question has had contacts.

4. Is the geographic region small enough to allow the individual to be gainfully employed in a similar industry elsewhere? Too often employers seek to enforce non-competition clauses over an area that is broader than their legitimate interests require. The broader the geographic area sought to be covered, the less likely the clause will be enforceable.

5. Was the contract actually signed before the individual started working? If not, there has been arguably no consideration for the promise and it is therefore unenforceable. Too often employers try to get employees to sign restrictive covenants after they have already been working for the employer. To be enforceable, such contracts require fresh consideration – and that consideration needs to be more than a token payment, or the promise of continued employment.

You may consider including a provision directing the court to reduce the period, or shrink the geographic area to the point where the court would consider the clause enforceable if they determine it otherwise is not. That may salvage something from an otherwise unenforceable clause.

Better to get appropriate advice before designing the clause in the first instance. ■

CANADA REVENUE AGENCY AGGRESSIVELY CHASING DIRECTORS PERSONALLY FOR TAX, CPP AND EI DEDUCTIONS THAT COMPANIES ARE FAILING TO REMIT

Paul L. Schnier

It is a well established principle of corporate law that a company and its shareholders are distinct entities and the shareholders are not liable for the debts and obligations of the company. Thus, many controlling shareholders of private companies are enticed into believing that they have no responsibility for their companies' liabilities.

Unfortunately, this is not the case where those shareholders also happen to be directors of their companies.

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most common, however, is probably the liability of directors under the *Income Tax Act* for unremitted source deductions.

Section 227.1 of the *Income Tax Act*, which is frequently invoked by the Canada Revenue Agency (CRA), makes directors personally liable for unremitted employee tax withholdings as well as for Canada Pension Plan and Employment Insurance deductions.

This liability is joint and several. This means that if one or more of the directors is unable to pay, the full liability lands on the rest who can.

There are essentially three defences to a director's liability assessment:

1. The CRA must demonstrate that it tried to collect the debt from the company and was unable to do so;
2. The assessment must be made within two years from the date that the individual ceased to be a director;
3. The "due diligence" defence…a director must demonstrate that he exercised the degree of care, diligence and skill to prevent the failure that a reasonably prudent person would have exercised in comparable circumstances.

There is much case law on the so called "due diligence defence" and what degree of care, diligence and skill is actually required.

The Canada Revenue Agency has not, in general, been very sympathetic to various tales of woe.

The courts have placed a heavy burden on "inside directors" but a lighter one on so called "outside directors" who are not involved in the day to day business affairs of the company. Nevertheless, the courts have still required even outside directors to demonstrate that measures were put in place to ensure that source deductions were remitted on time. The "it was someone else's job" defence seldom works. Similar provisions exist under the Goods and Services Tax and the provincial Retail Sales Tax legislation.

The Canada Revenue Agency has been quite aggressive of late in assessing directors for unremitted source deductions and GST. We have seen directors assessed for unremitted PST as well. Directors of private companies would do well to ensure that a system is in place for the timely remittance of these amounts and that they monitor this system on an ongoing basis so that nothing falls through the cracks. ■

WE ARE PLEASED TO ANNOUNCE

John C. Papadakis has been admitted to the Partnership.

John's corporate/commercial practice is focused on mergers and acquisitions and secured lending. He is particularly active in financings on behalf of institutional lenders. John can be contacted by telephone at 416.593.3998 or by e-mail to jpapadakis@blaney.com.

Blaneys on Business is a publication of the Business Law Department of Blaney McMurtry LLP. The information contained in this newsletter is intended to provide information and comment, in a general fashion, about recent cases and related practice points of interest. The information and views expressed are not intended to provide legal advice. For specific legal advice, please contact us.

We welcome your comments. Address changes, mailing instructions or requests for additional copies should be directed to Chris Jones at 416 593.7221 ext. 3030 or by email to cjones@blaney.com. Legal questions should be addressed to the specified author.

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