NON-COMPETITION COVENANTS IN A CANADIAN CONTEXT

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This article analyses the Canadian approach to the enforcement of non-competition covenants in franchise agreements. As a general rule, covenants restraining trade are unenforceable except in employer-employee and vendor-purchaser relationships. As the hybrid nature of franchising is such that it encapsulates both of these types of relationship, the courts have applied a broad range of analysis without any definitive trends emerging. The only clarity the case law offers is that contextual factors will be determinative in how non-competition clauses are interpreted.

As one would expect, the Canadian approach to the enforcement of non-competition covenants is rooted in English common law, which begins with the view that any agreement in restraint of trade is per se illegal.¹ In the Nordenfelt case, the House of Lords held that the courts should have regard to whether the restraint imposed is either a restriction that would prevent one of the parties to the agreement from earning his livelihood, or amounts to a hardship to the public, in depriving the community of the abilities of one of its members. The general principle enunciated in that case was that it was necessary to strike the balance between the freedom to contract and the desire to keep the limits imposed by such covenants fair and reasonable as between the parties and not contrary to the public interest.

The Supreme Court of Canada decision, Doerner v. Bliss and McLachlin Industries Inc.,² serves as the primary example of how Canadian courts approach non-competition agreements. As a general proposition, covenants restraining trade are unenforceable. Yet, the Canadian Courts recognize exceptions to this general rule in two primary relationships: employee-employer and vendor-purchaser.³ Over time, there has been judicial consideration of both of these exceptions. The test that has developed for enforceability of these covenants in Canada is based on “reasonableness.”⁴ Reasonableness (and thus enforceability) is measured in respect of three elements, namely the geographical area, the time period and the scope of the activities covered by the restriction.⁵ This approach gives the courts a wide range of discretion when considering the enforceability of these covenants. As a general rule, non-competition covenants should not be drafted any more restrictive than necessary for the protection

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³ Ibid. at 873.
⁴ Supra note 2.
⁵ Leonard Polsky, Dispute Resolution and Franchise Litigation in Canada (American Bar Association 27th Annual Forum on Franchising at the Sheraton Wall Centre Hotel, Vancouver) at p. 35.
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sought. Yet, at the same time, there is no specific criteria or analysis laid out by the courts to serve as guidelines. As a result, this area of law has developed in a very fact-sensitive way. What has remained constant over time is that the rules governing employment non-competes are far more exacting than those involving the sale of a business.

In the employment context, the Supreme Court has held that restrictive covenants will be unenforceable if any of their key terms are ambiguous. As a matter of policy, courts do not want to come to the aid of employers who use unclear contractual language to define the scope of their employees' post-employment obligations not to compete. Where it may be detrimental to an individual's ability to gain employment, courts are particularly insistent that such covenants not be overly restrictive or overly broad. The Supreme Court has held that "the restrictive covenant in an employment contract cannot be regarded as fed by the sale agreement and, to be enforceable, it has to stand up to the more rigorous tests applied in the employer/employee context."

An important aspect of the distinction in employment agreements is the element of unequal bargaining power. As Blair J. of the Ontario Court of Appeal stated in Tank Line:

"when two competently advised parties with equal bargaining power enter into a business agreement, it is only in exceptional cases that the courts are justified in over-ruling their own judgment of what is reasonable in their respective interests."

Logically, this relates to the ability of businesses to contract freely, without interference, while employees, on the other hand, do not usually participate in drafting their employment contracts. Since employment contracts resemble 'contracts of adhesion', they are to be interpreted more strictly by the courts and there is little to no judicial tolerance of unfair clauses.

The authors wish to note that this article considers only common law cases in Canada, and not any civil law decisions from the Province of Quebec.

NON-COMPETE CLAUSES IN FRANCHISE AGREEMENTS

While the Supreme Court has laid out a fairly clean body of law in distinguishing between the two exceptions for non-competition covenants (i.e. the sale of business and employment contexts), the question arises as to how non-competition covenants in franchise agreements should be treated? Which of these two exceptions, if any, should apply to a franchise relationship?

Arguably, a franchise can be characterized as a hybrid of a business relationship and an employment relationship. The essence of a franchise agreement is that the franchisor licenses to the franchisee the rights to use the franchisor's trade-mark and system under specific controls and standards, for a stated period of time, in exchange for financial consideration. In many franchise situations, the franchisee has little freedom in how the business is operated, possesses the rights granted for a limited period of time and loses the ability to operate a similar business following termination or expiration of the franchise agreement. Often, there is not much scope for the franchisee to negotiate changes to the franchise agreement, thus rendering a franchise agreement, in many cases, a contract of adhesion.

6 Ibid. at p. 35.
8 Supra note 7.
11 Supra note 2.
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As in the employment and sale of business context, there are very few principles that can be universally applied to non-compete clauses in franchise agreements. Only one pattern is clear: there is a large amount of judicial discretion involved in the interpretation of non-compete clauses, possibly even more so in the franchise context. How, then, does one discern judicial attitudes in advance when drafting such clauses? Our analysis must be fact-driven. Surveying a variety of cases shows us that no clear pattern has emerged; Canadian courts do not always favour the franchisor over the franchisee and vice-versa. However a closer examination of the cases in this area can offer us some interesting insights into judicial attitudes and a degree of comfort to at least know the safe limits in which to operate.

WHAT ARE SOME OF THE FACTORS COURTS CONSIDER?

A non-competition clause may be unenforceable if it fails to define with precision the exact type of business being restrained. In *Kynas v. Zippy Print Franchise Ltd.*, the defendant franchisor sought an interlocutory injunction to prevent a terminated franchisee from carrying on the "printing business" for eighteen months. The trial judge found that the language of the clause could not justify the granting of an interlocutory injunction because the "printing business" restriction was too broad, and the subject matter of the franchise was the quick printing business. As there was a distinction between the quick printing business, and the more general "printing business", the restriction should have been limited accordingly.

Overly broad clauses may also fail if they are unreasonable as to time and geography. This was what occurred in the case of *Yesac Creative Foods Inc. v. Hohnjec*, where a non-competition clause was found to be unenforceable because it restrained the franchisee from having an interest in any other business "which in any way is competing with the franchisor or its franchisees or which are related to the food, beverage or restaurant business." The trial judge believed the clause to be wider than necessary to protect the franchisor’s business interest and as a result it failed.

Perhaps if the franchisor had included limits on time and geography this would have been interpreted differently? Based on the court’s interpretation of the covenant in *Homelife/Signature Realty Ltd. v. Homelife Realty Services Inc.* this appears to be true. In that case, the plaintiff entered into a franchise agreement with the defendant franchisor, which provided in part that during the term of the franchise agreement the defendant would not grant a franchise or permit any existing franchise to establish an office within three kilometres of the plaintiff’s location. One of the defendant’s franchisees proposed to relocate within the restricted area, forcing the plaintiff to seek injunctive relief to stop that franchisee from doing so. The court held that the franchise agreement was very clear as to the scope it covered in time and geography. The covenant was not overly broad and there were no ambiguous terms, as a result, the non-compete clause was enforced.

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15 Ibid.

In Rapid-Med Plus Franchise Corp. v. Elliott et al., the restrictive covenant contained in the franchise agreement clearly expressed a geographical scope, but failed, in part, because that scope was too wide. It stipulated that the franchisee not compete within Manitoba or within the exclusive territory of any other franchise dealer in Canada. The court found it undesirable to restrict the entire area and limited its order to restricting the reach of the clause to the Province of Manitoba. The court, unusually, upheld some of the clause and not the rest, rather than rendering the whole clause unenforceable.

In some cases, Canadian courts are willing to intervene outside the scope of the franchise agreement in order to create a just result. This, however, is a rare occurrence. Bulk Barns Foods Ltd. v. Faber is an exceptional case where the court went beyond the scope of the franchise agreement to prevent an unfair outcome. The wife of a franchisee, whose agreement had expired, incorporated a new company and commenced to operate a competing business within the territory restricted by the agreement. The franchise agreement contained a provision requiring all shareholders of the former franchisee’s corporation to be bound by the non-competition covenant. Although the wife was a shareholder, this was never disclosed to the franchisor and she never executed a separate non-competition agreement. The court found that the wife must have known she was affected by the franchise agreement and assignment and she should not now be allowed to circumvent her legal obligation to the franchisor. The remedy granted was to issue an injunction against the wife and her corporation preventing them from continuing their business until the expiration of the two-year term of the husband’s non-competition covenant.

In Ontario Duct Cleaning Ltd. v. Wiles, a similar form of judicial intervention was taken. In that case, a franchisor was seeking an interim injunction restraining the defendant as well as another company, Advanced Air Quality (a non-party to the suit), from competing with it within the protected area defined in the franchise agreement. The franchisee had arranged for his wife and son to incorporate a new company for the purpose of competing with the franchisor. This deceitful act was not tolerated by the court and an injunction was issued against both the defendant franchisee and the new company. Despite being a non-party to both the litigation and the franchise agreement, it was held that the new company was incorporated for the sole purpose of avoiding the defendant’s non-competition obligations under the covenant and enabling the defendant to compete with the franchisor’s business.

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Considering Ontario Duct and Bulk Barn, it seems difficult to discern exactly which factors are influencing the judges. While these cases are perhaps anomalies, they are interesting because they highlight the extent to which the courts will intervene when a franchisee engages in sharp practices. There is no science to interpreting non-competition agreements. Both Bulk Barn and Ontario Duct tell us that the Canadian courts are willing to exercise judicial discretion to restrain both direct and indirect violations of non-competition covenants, even so far as to bind parties outside of the franchise agreement, simply to achieve an equitable result.
"... the “blue-pencil test” states that a restrictive covenant must either stand or fall as written, or be modified solely by removal of offending phrases.”

Yet, in other situations, courts have not been willing to bind third parties. In *Saint Cinnamon* 21, the plaintiff sought an interim injunction restraining a third party and its principal (the father of the covenanter and defendant in the action) from running a competing business, contrary to the franchise agreement. The plaintiff alleged that the third parties acted unfairly and in concert with the defendant to deliberately breach the franchise agreement and non-competition clause. The court found that the clause did not prevent previous employees of the franchisor from working in similar restaurants, nor did it prevent third parties from operating a similar business to the franchise. The defendant’s activities were not a direct breach of the covenant and thus the court did not grant an injunction. This New Brunswick decision almost completely contradicts the views taken by the courts in *Bulk Barn* 22 and *Ontario Duct Cleaning* 23, once again highlighting the inconsistencies of courts in their interpretations of non-compete covenants.

**HOW TO AVOID INVALID NON-COMPETITION CLAUSES?**

A review of the case law in this area suggests that there is no patterned approach to interpretation. In fact, the plethora of different factors and approaches taken by different courts tells us that the only certainty in predicting how courts will apply these clauses in the future is uncertainty. As lawyers, this can be difficult and frustrating to explain to our clients. Are there any trends in the exercise of judicial discretion that we can present to our clients? In short, the answer is no. However, there are certain factors which warrant our attention when drafting non-compete clauses.

**Be aware that, if necessary, courts will sever or modify clauses where they see fit**

As a rule, Canadian courts take a strict approach to the enforcement of non-competition agreements and will not rewrite a non-competition covenant to make it reasonable and enforceable. 24 The general rule is that a covenant may be severed from an agreement when the remaining provisions are capable of standing alone. 25 What has been labelled as the “blue-pencil test” states that a restrictive covenant must either stand or fall as written, or be modified solely by removal of offending phrases.

There are relatively few cases where courts have modified a restrictive covenant, but it has been known to happen. 26 In *Fareway Coach Lines* 27, the restrictive clause, which intended to limit bus tours, did not specify this nor did it include the specific boundaries within which the tours were to operate. Not unexpectedly, it was challenged on the basis of being overly broad. Rather than striking down the clause however, the court looked at the agreement as a whole and found there was no ambiguity in the clause. Essentially, the court re-wrote the non-competition covenant to include the necessary restrictions to make it an appropriately enforceable clause. This is a fairly rare exception. This case has not been widely followed or quoted from in subsequent cases. 28

Yet, in other cases, courts have modified non-competition clauses by severing unreasonable terms to make the agreements reasonable and enforceable, such as in *Rapid-Med* 29. The restrictive covenant

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21 Ibid.
22 *Supra* note 18.
23 *Supra* note 19.
24 *Supra* note 13.
27 Ibid.
28 *Supra* note 5 at p. 43.
29 *Supra* note 17.
provided that, following the termination of the agreement, the franchisee would not compete with the franchisor within Manitoba or within the exclusive territory of any other franchise dealer in Canada. Ambiguity was not at issue in this covenant. It simply covered such a broad territory that it was unreasonable. The court found it undesirable to enforce such a broad geographic scope and, instead, restricted the wording of the agreement to only the Province of Manitoba. As each area was separately defined in the contract, the judge found it possible to sever the clause and still uphold it. However, this was not the approach taken in a subsequent Manitoba Court of Appeal decision, Horizon Custom Builders, where the Court refused to alter the wording of the non-competition agreement on the basis that it could become an issue at trial. The Court held that it would be inappropriate to re-word a covenant pending a trial where the issue was a lack of certainty in that covenant, rather than simply an argument based on unreasonableness. Unlike in Rapid-Med, since ambiguity existed in the terms of the covenant, the court was unwilling to modify it.

Be aware that courts will often interpret clauses at face value

These decisions, however, are by no means a trend. Often, rather than delving deeply into the intended meaning behind the covenants, courts are more likely to enforce them at face value, irrespective of what was intended. Such was the case in Dynamex Canada. An application was made for an interlocutory injunction to restrain breach of restrictive covenants contained in the franchise agreement, which prevented the franchisee from operating a similar business for a two-year period after terminating the agreement. The franchise business was an overnight courier service and the franchisee, after leaving the franchise, opened a same-day courier service. The judge did not accept that same-day and overnight courier services were similar enough to grant an injunction against the former-franchisee. Rather than taking an involved, contextual analysis of the covenant, in Dynamex the interpretation of the covenant appeared to be strict. The judge was reluctant to re-write the agreement or add any meaning to it not plainly stated.

In fact, in Canadian American Fin. Corp. v. King, Southin J.A. of the British Columbia Court of Appeal discusses the “blue pencil” rule and elaborates that, in its strict form, it should not be considered as a rule of law and should not be applied as such in British Columbia. He states that it is not a function of the courts to act as de facto arbitrators over clauses that are drawn as alternatives. If a covenant is unreasonable in its scope (although unambiguously so), it is not for the courts to use the “blue pencil” rule to make an agreement for the parties which they were unable to make for themselves. This is a strong pronouncement from the Court which suggests that, at least in B.C., it seems unlikely that courts would apply the “blue pencil” rule to non-compete covenants. It is more likely that such covenants would be taken at face value. Whether this will become the trend in other provinces, however, remains to be seen.

Be aware that ambiguity will likely be construed against the drafter of the clause

There appears to be a danger in being overly broad or overly narrow when drafting non-competition clauses. It is impossible to advise which is safer, as the nature of these decisions are very fact-driven. In Shelanu v. Print Three Franchising Corp., the Ontario Court of Appeal cites the Supreme Court of Canada on non-competition clauses:

"Exclusion clauses are to be approached with the aid of the cardinal rules of contractual construction: they must be read contra proferentem and clear words are necessary for the exclusion clause to apply."
Often, the franchise agreement is a contract of adhesion. In essence a “take it or leave it” proposition for the franchisee.\textsuperscript{36} As such, any ambiguity will be interpreted against its author, as happened in the Salah case and in Aamco Transmissions Inc. v. Kunz\textsuperscript{37}. In the Aamco case, the Saskatchewan Court of Appeal, referring to Chitty on Contracts, 24th ed. at p. 334, stated that a franchise agreement is one which is subject to being interpreted against the grantor.\textsuperscript{38}

4. Be aware that there is no clear preference between broad or narrow clauses

Courts are generally reluctant to enforce overly broad non-competition clauses. In Synergism Arithmetically Compounded Inc.\textsuperscript{39}, the court mused that:

"various issues will have to be canvassed at trial before one of the covenants in restraint of trade is enforced against the defendants, such as whether the nature of the business described is broader than necessary or the area unduly large, or whether the covenant is void for uncertainty. Another issue is the period of time during which the covenant is operative if enforceable."\textsuperscript{40}

Unfortunately, despite providing a list of factors to consider, no insight was offered as to how to apply such factors. The lack of consistency has led to a gap in the analysis. What is seen as too broad or too narrow will ultimately depend on the facts of each case. It is impossible to predict what any court will do when faced with a non-compete clause in a franchise agreement and even more difficult when the approaches are so radically different.

For instance, as previously mentioned, in Kynas v. Zippy\textsuperscript{41}, “the printing business” was considered too broad. The court felt that this restriction was too general and, accordingly, unenforceable. A more narrow restriction, such as “quick printing business” would likely have saved the offending clause in this case.

Yet, it seems impossible to win. Even when a covenant does include narrow terms, that in and of itself can cause the covenant to fail.\textsuperscript{42} In Roblan Distributors Ltd.\textsuperscript{43}, a non-competition covenant prohibited the franchisee from carrying on another retail business dealing with the sale of compact disks and cassettes for three years within a 25 mile radius of the terminated franchise or any other franchise location in Canada. The judge found this covenant unreasonable. Its terms were found to be so restrictive that it was declared void.

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\textsuperscript{38} Ibid. at para 81.


\textsuperscript{40} Ibid. at para 34.

\textsuperscript{41} Supra note 13.


\textsuperscript{43} Ibid.
CONCLUSION

What does this tell us about non-competition clauses in the franchise context? As this article has suggested, judicial attitudes are central to the interpretation of non-compete covenants in franchise agreements. As of yet, it is difficult to pinpoint a consistent trend in judicial attitude throughout the cases. This demonstrates that this branch of law, dealing with non-competition clauses, is not as well settled as the two exceptions for employment and sale of business laid out by the Supreme Court in Doerner v. Bliss.\(^4\) The nature of franchising is such that it encapsulates both employee-employer and vendor-purchaser like relationships. Perhaps this explains why there is such a broad range of analysis in the spectrum of these cases. The hybrid nature of franchising means there is no one direction that courts can take their analysis. The only clarity offered by the courts is that contextual factors will be determinative in how they are to interpret non-competition clauses. Perhaps as the law evolves courts will guide us in clearer directions.

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\(^{44}\) Supra note 2.