

Know The Limit, Play Within It: Restrictive Covenants In Canada



Introduction

A restrictive covenant is a provision in a contract to restrict, limit or prevent certain actions by one or more parties to that contract. Also referred to as a “negative” covenant, restrictive covenants serve to mitigate risk and conflicts (real or perceived) by placing constraints on the conduct of one or all of the contractual parties (as opposed to a “positive” covenant, which is a provision pursuant to which a party agrees to perform a certain action).

In our experience, mergers and acquisitions (“M&A”) practice around restrictive covenants, particularly around the inclusion of blue-pencil provisions, is an area where Canadian M&A transactions and U.S. and international M&A transactions notably differ.¹ Accordingly, this article may be of particular interest to aid U.S. and international purchasers and their advisers in how restrictive covenants in the Canadian M&A context may differ from their own M&A practices.

This article also provides an overview to U.S. and international purchasers and their advisers of Canadian restrictive covenants in the Canadian employment law context. The focus of this article is the treatment of restrictive covenants under the laws of the Province of Ontario. There are differences between the treatment of restrictive covenants under the laws of the other provinces of Canada, though the principles are generally applicable.

Restrictive covenants take numerous forms and are incorporated into contracts for various purposes. In M&A and employment law contexts, two prevalent forms of restrictive covenants are non-competition and non-solicitation clauses,² with such clauses frequently integrated into agreements to safeguard the economic interests of the non-restricted party.

In this article, we describe what non-competition and non-solicitation provisions are, provide an overview of the nuances between such restrictions in these two separate contexts, and discuss “reasonableness” and drafting guidance, as dependent on the context of the restrictive covenant.

Non-Competition and Non-Solicitation Clauses – What Are They?

Non-competition clauses restrict an individual or entity’s ability to engage in

certain competitive activities, typically after the termination of their employment or upon the completion of the sale of a business. For example, a party may be restricted from engaging in a similar profession or trade within a specific geographic area for a certain amount of time, and/or may be restricted from investing in a certain percentage of a competing enterprise.

Non-solicitation clauses restrict, during a defined period of time, certain individuals or entities from soliciting or inducing persons, including, for example, clients, customers, vendors, employees or independent contractors that have some contractually defined affiliation with the party imposing the restrictions. For example, subject to certain exceptions, such as for non-targeted general solicitations, this could include restrictions on actively enticing clients away from a business, soliciting employees or independent contractors, or persuading vendors, customers or suppliers to sever their ties with the party protected by the clause.

Generally, in M&A agreements, non-competition and non-solicitation clauses protect the purchaser. Having made a substantial investment in the business on the basis that part of what is being acquired is the “goodwill” of the business, Ontario courts recognize that, for a specified time, the purchaser should be free to establish relationships with the business’ existing customers without being concerned the vendor may establish or otherwise work in a competing business. On the other hand, in employment agreements, these covenants, in tandem with confidentiality and intellectual property protections, protect the employer’s interests. As detailed below, the enforceability and treatment of these clauses (and non-competition clauses in particular) differs greatly in the context of M&A transactions versus employment relationships.

Non-Competition and Non-Solicitation Clauses – M&A Context

Courts typically afford deference to restrictive covenants when scrutinizing them within the context of M&A transactions.³ Courts generally consider parties engaged in such transactions to possess equal bargaining power, expertise and access to resources, with the parties themselves recognized as best positioned to determine what is reasonable for the purposes of the restrictive covenants. Moreover, such transactions often involve an explicit or inherent payment to the vendor for goodwill. Sales of goodwill impose certain obligations on the vendor. Notably, in the context of M&As, the Supreme Court of Canada (“**Supreme Court**”) has recognized that the sale of goodwill can only be protected by restrictive covenants.⁴ In *Elsey*, the Supreme Court observed that a business could be considered an “unsaleable commodity” if a purchaser is unable to bar the vendor from competing.⁵ Similarly, in *Shafron*, the Supreme Court referenced an 1894 House of Lords case which held that the restrictive covenant “must be taken as entered into in connection with” the protection of the sale of goodwill.⁶

What Makes a Restrictive Covenant “Reasonable”?

Courts will enforce restrictive covenants in M&A transactions, so long as they are “reasonable.” This reasonableness standard has been reaffirmed in recent case law to be “no more than adequate for its intended purpose” – a relatively low bar to meet.⁷ Courts have emphasized that they should intervene only in extraordinary cases where parties with equal bargaining power have made unreasonable judgments. Various factors, including but not limited to the sale price, nature of business activities and the parties’ experience, can play a role in determining what is considered “reasonable” in the specific circumstances of a given transaction.

Drafting Guidance

Given the favourable judicial interpretation of reasonableness in the context of M&A transactions, restrictive covenants can be drafted to be relatively broad. However, when drafting such covenants, parties should still be mindful of the following three factors: (1) the breadth of activity that is restricted; (2) the breadth of the geographical area of the restriction; and (3) the length of time where the applicable activity is prohibited. These factors should be clearly defined and justifiable in relation to the context of the transaction. For example, an acquisition of several dental clinics containing a non-compete agreement that prohibited the vendor from practising at any dental clinic within a 10-kilometre radius of the clinics he had sold was held to be enforceable and reasonable.⁸ While there was no challenge to the breadth of restricted activity or the 10-kilometre radius, the court held that a five- to six-year time limit for this prohibition was a reasonable length of time for the buyers to take advantage of the restrictive covenant. Generally speaking, time frames of three to five years are common for restrictive covenants, depending on the size and nature of the transaction, including the degree of competitiveness in the target's industry and market.

Despite the general enforceability of broad restrictive covenants, the reasonableness of restrictive covenants in M&A transactions can still be unenforceable in Canadian courts. In 2021, the Supreme Court [denied](#) leave to appeal a [decision](#) by the Alberta Court of Appeal to apply the doctrine of notional (or "blue-pencil") severance (the judicial doctrine of reading down a covenant by, for example, decreasing the geographic scope or time limit in order to render it reasonable and enforceable). While this leave to appeal opened the doors for other Canadian courts to adopt similar reasoning to permit blue-penciling, there has been no case law in Ontario since 2021 that addresses this matter. Where restrictive covenants are determined to be unreasonable, the court will find the entirety of the restrictive covenant unenforceable.⁹ It remains to be seen whether courts in other provinces and territories outside of Alberta will blue pencil a restrictive covenant that may be challenged by a party to an M&A transaction. Accordingly, generally speaking, our recommendation is to draft restrictive covenants in these contexts to be no more broad than necessary, avoiding the inclusion of a blue-pencil provision.¹⁰

Non-Competition and Non-Solicitation Clauses – Employment Context

The Supreme Court has long recognized a power imbalance between employers and employees.¹¹ As such, restrictive covenants and, in particular, non-competition provisions have long been scrutinized by Canadian courts for interfering with individual liberty and restraining the ability for individuals to earn a living based on their skills, ruling them as presumptively non-enforceable.¹²

What Makes a Restrictive Covenant "Reasonable"?

In employment contracts, restrictive covenants not prohibited by the ESA amendments will be held to a much higher standard of reasonableness than in the M&A context. In employment relationships, if a restrictive covenant is challenged, the employer will be required to demonstrate that the clause is justified and sufficiently narrow for the legitimate protection of their business interests. This is particularly the case where an employer will have to demonstrate that non-solicitation provisions, intellectual property and confidentiality protections, as well as non-disclosure agreements, which remain broadly permissible and do not attract nearly the same level of scrutiny, are insufficient to protect legitimate business interests. Nonetheless, as with any restrictive covenant, the courts will assess whether the non-solicit provision is necessary to protect the legitimate business interests of the parties. Employers should also take note of separate and important *Competition Act* restrictions on entering into agreements with each other not to solicit or hire

each other's employees, per our [prior guidance](#).

Drafting Guidance

Where non-compete clauses are permitted in the employment context,¹³ we recommend using the narrowest and most specific language possible to capture the breadth of the geographical area of the restriction, the length of time, the breadth of activity that is restricted and a detailed description of the business. Any ambiguity in a covenant is likely to render it unreasonable and unenforceable. For example, in a 2021 case heard by the Ontario Superior Court of Justice, a non-compete clause prohibited a financial advisor from engaging in almost any work involved in the securities industry across Ontario for two years after he left his position. The court found this breadth of activity to be unreasonably broad as it prohibited the financial advisor from earning a living anywhere in Ontario.¹⁴ Generally speaking, it is rare to see a non-compete clause exceeding six months in the employment context enforced by a court, subject to rare exceptions with corresponding lengthy periods of severance (despite this being an equitable concept, and not being part of any legal test to establish "reasonableness"). Like in the M&A context, geographical limits and descriptions of business activities will be context-specific but need to be demonstrably justifiable in respect of a company's actual and legitimate business interests, and corresponding necessarily protections. References to "global" or even continental restrictions are, in most cases, considered too broad by Canadian courts.

Employers should be precise when formulating restrictive covenants in employment contracts and when updating existing employment agreements that pre-date the ESA amendments.

Conclusion

While restrictive covenants serve to safeguard economic interests in both M&A transactions and employment relationships, their treatment varies significantly across the two contexts. The nuances must be understood to ensure such covenants are both enforceable and reasonable in each specific situation.

One additional and natural question that readers may ask themselves is: What happens in the context of an M&A transaction by virtue of which some or all of the seller parties become employees of the purchaser and thereby have restrictive covenants both under the purchase agreement (or an ancillary restrictive covenant agreement) and an employment agreement with its own restrictive covenants? In practice, it is entirely possible that the covenants arising from the transaction may run their course while the seller parties remain employed, leaving the purchaser/employer wanting the protections associated with a termination of employment at a later date. Most often, the "longer of" concept will come into play, meaning that the longer of the two periods will prevail. Drafters are wise to address the duality or "longer of" concept in writing, such that the purchase agreement (or related restrictive covenant agreement) and employment agreement and its covenants do not, on their face, conflict with each other or create ambiguity post-closing since, as outlined above, post-closing ambiguity will be resolved in favour of the party that is seeking to undertake certain activities rather than the party seeking to restrict those activities.

Footnotes

1. Please see our article, [Important Canadian Legal Considerations and Market Practices for U.S. and International Purchasers in Cross-Border Private M&A Transactions \(airdberlis.com\)](#), for additional differences between Canadian M&A transactions and non-Canadian M&A transactions.

2. Other types of restrictive covenants include non-disparagement and non-hire covenants, which have

been omitted from this article for the sake of brevity.

3. For example, in [UAP Inc. v. Yako, 2021 ONSC 5065](#) at para 31, the Ontario Superior Court of Justice implied that deference is afforded to contracting parties in such situations when it held that a party who imposed the restrictive covenant for its own benefit “must live by its terms.” In [Dentalcorp Health Services v. Poorsina, 2023 ONSC 3531](#) [DentalCorp], the same court provided that only in exceptional cases should the court overrule the judgment of parties regarding restrictive covenants where the parties entered into a business agreement, were advised by counsel, and had equal bargaining power.

4. See [Shafron v. KRG Insurance Brokers \(Western\) Inc., 2009 SCC 6](#) [Shafron] and [Elsey v. J.G. Collins Ins. Agencies, \[1978\] 2 SCR 916](#) [Elsey].

5. Elsey, *supra* note 4 at para 15.

6. Shafron, *supra* note 4 at para 21; *Nordenfelt v. Maxim Nordenfelt Guns and Ammunition Co. Ltd.*, [1894] A.C. 535 at page 555.

7. See [Tank Lining Corp. v. Dunlop Industrial Ltd., 1982 CarswellOnt 780](#), and DentalCorp, *supra* note 3 at para 23.

8. See DentalCorp, *supra* note 3.

9. See [Martin v. ConCreate USL Limited Partnership, 2012 ONSC 1840](#) at para 25.

10. While in M&A agreements, we typically would include a severability provision which provides that if any provision of the agreement is held invalid by a court decision, statute or rule, or shall be otherwise rendered invalid, the remainder of the agreement will remain unaffected, we typically do not include blue-pencil provisions in such agreements.

11. See Shafron, *supra* note 4 at para 23.

12. As reported in a [previous newsletter](#), Bill 27, the *Working for Workers Act, 2021*, amended the *Employment Standards Act, 2000* (the “ESA”) to prohibit employers in Ontario from including non-competition clauses that restrict competition following termination of employment in employment contracts, or any other type of agreement. Non-competition agreements entered into before October 25, 2021, are not automatically void under the ESA amendments; however, they will still be heavily scrutinized using a similar three-part test to assess their “reasonableness” as articulated above. The ESA now articulates two exceptions to the strict non-permittance of non-competition provisions. In recognition of the unique M&A context summarized above, one exception applies in the context of a sale of a business where, if immediately following the sale, the vendor becomes the purchaser’s employee, and as part of the sale, the purchaser and vendor enter into a non-compete agreement, it will not be automatically void by the ESA. The second exception applies when an employee holds an executive position such as chief executive officer, president, chief financial officer, or any other chief executive role. It should be noted that even for such senior roles, the provision will still be tested for “reasonableness.”

13. As previously [advised](#), the Government of Ontario’s [guide to the ESA](#) provides further clarification on Bill 27’s prohibition of non-compete clauses and agreements: any agreement may be considered a non-competition agreement, regardless of whether or not it contains a time-limit or geographic restriction. Further, other than relationships exempt from the ESA amendments as noted above, parties are prohibited from entering into non-compete clauses or agreements at any time (before, during and after the employment relationship ends), which should not to be confused with the ability to require non-competition by an employee while *they are actively employed*.

14. See [Mandeville Holdings Inc. v. Santucci, 2021 ONSC 4321](#).

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

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