LAW REFORM COMMISSION OF BRITISH COLUMBIA

REPORT ON
COVENANTS IN RESTRAINT OF TRADE

LRC 74

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The Law Reform Commission of British Columbia was established by the *Law Reform Commission Act* in 1969 and began functioning in 1970.

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TO THE HONOURABLE BRIAN R.D. SMITH, Q.C.,
ATTORNEY GENERAL OF THE PROVINCE OF BRITISH COLUMBIA:

The Law Reform Commission of British Columbia has the honour to present the following:

REPORT ON COVENANTS IN RESTRAINT OF TRADE

In this Report, we examine the difficult questions posed by the common law rules governing covenants in restraint of trade. In an attempt to balance the public policy favouring the unrestricted ability of a person to engage in productive economic activities with the legitimate concern of employers, vendors of businesses, franchisors and persons in similar positions, courts have historically enforced a covenant in restraint of trade only if it was reasonable in the interests of the parties and of the public. If it was unreasonable in any respect, then it was completely unenforceable.

Modern business practice, the increased complexity of modern society, and the changing judicial perception of the relevant factors to consider in determining the essential question of reasonableness, have all combined to call into question the rule that an unreasonable restraint is wholly unenforceable. The recommendations contained in this Report strike a fairer balance between covenantor and covenantee. When implemented, they will, in many cases, render a covenant partially enforceable which would otherwise be unenforceable in its entirety.

CHAPTER I INTRODUCTION

A. Background

This Report is one of a series examining the rights of parties to a transaction when a mistake is made in its formation or performance. Our *Report on The Recovery of Unauthorized Disbursements of Public Funds*, examined the law governing the Crown's right to recover money paid in error without statutory authority. Our *Report on Benefits Conferred Under a Mistake of Law* examined the law governing the position of a person who, while acting under a mistake of law, confers a benefit on another. Most recently, our *Report on Illegal Transactions* examined the position of parties to an illegal transaction. We hope to examine, in a future Report, issues arising out of contractual mistakes.

A project on covenants in restraint of trade formed part of the Commission's original program, but work was discontinued in 1972 in view of competing demands on the Commission's resources. However, the project on illegal transactions again brought the issue of covenants in restraint of trade to the forefront. In view of recent developments in the law, this subject appeared ripe for examination.

B. Why Examine Covenants in Restraint of Trade?

While the policy of the law favours free competition in the marketplace, the interests of employers and businesses do not necessarily lie in unrestricted competition or in the free flow of labour. Accordingly, the questions raised by covenants in restraint of trade may be examined in a number of different contexts. A business which has lost an executive may have a legitimate interest in preventing him from divulging its business secrets to competitors, or from taking advantage of his former position by "stealing" customers. Frequently the agreement under which an employee is hired prohibits him from setting up business on his own account on leaving his employer's service or entering into employment with a rival firm. Similarly a person who has bought a small business may be justifiably upset if the vendor reopens next door. A contract for the purchase of a business and its goodwill frequently prohibits the seller from carrying on a competing business. Large manufacturers and producers often seek to preserve and enlarge their market share by agreements which bind a retailer or the purchaser of a franchise to deal exclusively with the manufacturer or producer. These and similar types of contracts are often the subject of litigation in the courts of British Columbia.

In our earlier *Report on Illegal Transactions*, we concluded that the general rule governing an illegal transaction was in need of reform. That general rule may be simply stated. An illegal transaction is unenforceable by action, and, moreover, courts will not entertain any action based upon any matter arising out of the illegal transaction. This rule operates in an exceedingly complicated manner. It is useful, however, to compare the general rule to that governing covenants in restraint of trade. A contract to the extent it is in restraint of trade is unenforceable *unless* the restraint is no broader than is reasonable in the circumstances. Covenants in restraint of trade therefore form a unique category of illegal transaction, in the sense that courts are willing to temper the strict application of public policy. The reason for this more lenient attitude is based on the conflicting heads of public policy involved.

The test of "reasonableness" as the *sine qua non* of enforceability brings with it a host of problems. Not only have courts divided on the question of the content of the test, but there exist as well practical problems in its application. In particular, this Report is concerned with the effect on the parties when a covenant in restraint of trade is struck down and adjudged to be unenforceable. Assume, for example, that A sells his shoe store to B. A large portion of the purchase price is devoted to the goodwill attached to the business. The shoe store is located in Burnaby. In such a case, B will wish to impose upon A a covenant not to compete with B, in order to preserve the goodwill of the business. What limitations can B legitimately place on A? Can A lawfully covenant not to open a shoe store in New Westminster? Surrey? Langley? Chilliwack? Should B err and describe the area in which A is forbidden to trade, the duration of the restriction or the nature of A's activities in too broad a fashion, then the covenant is completely unenforceable. A would be free to reopen next door to his old shoe store and, moreover, he would not be obliged to refund any of the purchase price. It is open to question whether such a drastic result should follow upon an innocent mistake.

Striking down a covenant in restraint of trade has an obvious economic impact on the parties to it. Freeing the covenantee from his obligations could result in devastating consequences to the covenantor. Those economic consequences will, of course, vary according to the nature of the contract in which the covenant in restraint of trade is found. In a sale of a business, striking down a covenant could result in the vendor/covenantor being placed in a position to recover the goodwill of the business without coming under any corresponding obligation to refund the purchase price. In a franchise agreement, substantial funds spent by the franchisor on promoting the franchise, increasing its goodwill, and, perhaps, subsidizing the franchise's early operations, could be wasted. Moreover, the franchisor could lose the benefit of an assured outlet and could see its marketing plans severely disrupted for that reason. Similar consequences might be anticipated if an exclusive dealing agreement is struck down as in restraint of trade. The damage to an employer should a covenant in restraint of trade be struck down may be both short and long term. Expenditures related to employee development may be rendered nugatory. The exemployee in addition may retain such an intimate knowledge of his exemployers' operation, and of his customers, that in the long term, armed with knowledge generally unavailable to the exemployer's other competitors, the exemployee may prove to be very effective competition indeed.

Of more concern is the impact a decision respecting the validity of a covenant in restraint of trade may have on an industry as a whole. As each covenant is tested, and either upheld or struck down, careful draughtsmen will model future covenants on it, or redraw covenants to avoid its effect. The shape of an entire industry may be determined by *ad hoc* decisions taken by single judges unassisted by expert evidence. This is a matter to which we shall turn later in this Report.

It must be noted that the problems posed by covenants in restraint of trade may arise in a large number of factual contexts. It is useful to keep in mind the four common areas where these covenants usually arise. These are:

(i) in agreements for the purchase of a business; to prevent competition and protect goodwill purchased;
(ii) in franchise agreements; to protect confidential information and "know how" provided by the franchisor to the franchisee for the running of a business, as well as the good will associated with the franchisor's business name;
(iii) in solus agreements between suppliers who wish to market effectively their goods and distributors who desire an assured and economic source of those goods; and
(iv) in employment agreements, where the employer wishes to protect confidential information and business prospects should the employee leave his employment.

C. Terminology

In this Report, we use several terms which it is useful to define at this point.

1. Covenant

A covenant is technically a promise contained in a deed. In its broadest usage, it includes any contract, or portion of a contract containing a separate obligation. In this Report it is used in its broadest sense.

2. Covenantor

The person who agrees to limit his activities in accordance with a contract or provision of a contract in restraint of trade.

3. Covenantee

The person who imposes upon a covenantor a contract in restraint of trade and for whose benefit a term in restraint of trade is inserted in a contract.

4. Overreaching

This word is used to describe a covenant in restraint of trade which is broader than the reasonable and legitimate business interests of the covenantee require. This concept is discussed in detail in Chapter VI of this Report.

5. The General Rule

By this term we mean the rule that a covenant in restraint of trade is unenforceable unless the restraint in issue is reasonable in the circumstances of the case.

D. The Report

In Chapter II of this Report, we discuss the current law governing covenants in restraint of trade. In Chapter III we concentrate on the test of reasonableness and its application in modern cases on restraint of trade. In Chapter IV we examine the policy underlying the present law governing covenants in restraint of trade and relate that policy to the practical effect of its application. Lastly, in Chapters V and VI we make recommendations for reforming the law.

CHAPTER II CURRENT LAW

A. Development of the Law

Over the years, the attitude of common law courts towards covenants in restraint of trade has not been consistent. As Pollock has noted, the historical change in attitude was:

> a singular example of the common law, without aid from legislation and without any manifest discontinuity, having partially reversed its older doctrine in deference to the changed conditions of society and the requirements of modern commerce.

The hostility of courts to agreements in restraint of trade is of comparatively recent origin. In medieval times, trade was generally controlled by guild and manorial custom, although some legislative efforts were made to control the efforts of middlemen to monopolize or otherwise interfere with the normal distribution of food. The Crown made a practice of granting monopolies, a prerogative lost only after a protracted constitutional struggle.

With the gradual expansion of trade and the growth of British industry, common law courts changed their attitude towards such arrangements, and were prepared on occasion to strike them down. The courts, for example, sought to limit the power of the guilds to control access by the public to skilled workmen. In the early seventeenth century *Ipswich Tailor's Case*, the court considered a regulation that no one should carry out the trade of a tailor without the guild's approval, and stated:

> ... at the common law, no man could be prohibited from working in any lawful trade, for the law abhors idleness, the mother of all evil ... and especially in young men, who ought in their youth (which is their seed time) to learn lawful sciences and trades which are profitable to the commonwealth and whereof they might reap the fruit in their old age, for idle in youth, poor in age; and therefore the common law abhors all monopolies, which prohibit any from working in any lawful trade ... if a husbandman is bound that he shall not sow his land, the bond is against the common law ... [The rules in question] are against the liberty and freedom of the subject, and are a means of extortion in drawing money from them, either by delay or some other subtle device, or of oppression of young tradesmen by the old and rich of the same trade, not permitting them to work in their trade freely; and all this is against the common law and the commonwealth.

Despite such strong language, it became settled that a guild bylaw was valid if it rested on custom and was beneficial to the general public, thereby foreshadowing the modern rule. In contrast, any other restraint on individual rights to trade came to be regarded as void.

The high point of the view that covenants in restraint of trade were so pernicious as to be completely void is the *Dyers Case*. The defendant entered into a bond not to practise the trade of dyer for six months. In an action on the bond, Hull J. stated:Why did Hull, J. think the bond illegal? Some have suggested that restraints in bonds were intrinsically more oppressive than in other contracts and were more likely to be struck down. ... In any event, there is no reason to suppose that Hull, J., accepted the distinction. Another suggestion is that *Dyer's Case* does not depend on "any special vice in the bond [but reflects a general] medieval view... that any restraint upon the freedom of a man to carry on his trade or profession was completely void." But it is questionable whether there was such a general view; life was riddled with customary restraints and restrictive agreements were not unusual.

> By God, if the plaintiff were here he should go to prison until he paid a fine to the King.

The confusion in the early cases reflects the changing economic system in England. With the demise of the guild system, public and judicial acceptance of trade restrictions waned. At the same time, the courts recognized that outside the guild system it might still be necessary in certain cases to stipulate for non competition clauses. The courts shifted from an attack on the monopolistic powers of guilds to considering the extent to which consensual limitations on trade should be enforced.

The culmination of these developments was the case of *Mitchel* v. *Reynolds*. The defendant had assigned the lease of a bakehouse to the plaintiff, and gave a bond for £50 that he would not work as a baker for five years. In an action to recover the penalty upon the defendant's breach, the penalty was upheld. In his judgment, Parker C.J. stated:

> The plaintiff took a baker's house, and the question is whether he or the defendant shall have the trade in this neighbourhood; the concern of the public is equal on both sides.
>
> What makes this the more reasonable is that the restraint is exactly proportioned to the consideration, *viz*. the term of five years.
>
> To conclude: in all restraints of trade, where nothing more appears, the law presumes them bad; but if the circumstances are set forth, that presumption is excluded and the court is to judge of those circumstances and determine accordingly; and if upon them it appears to be a just and honest contract, it ought to be maintained.

In so holding, Parker C.J. distinguished cases dealing with monopolies, bylaws, regulations and other nonconsensual restraints, which he stated were absolutely void. Parker C.J.took a number of factors into account in formulating a general rule that a covenant, just and honest in the circumstances, should be valid and enforceable. A contract in restraint of trade would be enforced if it was for good consideration, and if "proper and useful." Although ParkerC.J. was of the view that it was lawful for a man to "part with his trade," he also stated that "no man can contract not to use his trade at all." Unlike involuntary re-

straints (which are void because they discourage "trade and honest industry" and violate *Magna Carta* provisions respecting the use by free men of their tenements, customs and liberties) voluntary covenants were said to be void not because they infringed *Magna Carta* (since a man could voluntarily circumscribe his own freedom of action), but rather because of:

> ... the mischief which may arise from them, 1st, to the party, by the loss of his livelihood and the subsistence of his family; 2dly, to the publick, by depriving it of an useful member.
>
> Another reason is the great abuses these voluntary restraints are liable to; as for instance, from corporations, who are perpetually labouring for exclusive advantages in trade, and to reduce it into as few hands as possible; as likewise from masters, who are apt to give their apprentices much vexation on this account and to use many indirect practices to procure such bonds from them, lest they should prejudice them in their custom when they come to set up for themselves.

Mitchel v. *Reynolds* clearly established a general requirement that restrictive covenants are unenforceable unless "reasonable." Moreover, the "reasonable" test articulated in that case applied not only to the interests of the public, but also to the interests of the covenantor.

It may be doubted whether Parker C.J.'s condemnation of general covenants in restraint of trade was meant to apply to covenants other than bare agreements not to compete, such as the bond considered in the *Dyer's Case*. However, it was well established by 1839 that a general covenant not to compete within the United Kingdom was void, where a less broadly stated restriction might be enforced. In *Ward* v. *Byrne*, Parke B. held:

> Now where a limit as to space is imposed the public, on the one hand, do not lose altogether the services of the party in the particular trade he will carry it on in the same way elsewhere; nor within the limited space will they be deprived of the benefit of the trade being carried on, because the party with whom the contract is made will most probably within those limits exercise it himself. But when a general restriction, limited only as to time, is imposed the public are altogether losers, for that time, of the services of the individual and do not derive any benefit whatever in return ...

During the 19th century, the utility of this distinction came to be doubted, and in the seminal case of *Nordenfelt* v. *Maxim Nordenfelt Guns and Ammunition Co.*, it was abandoned altogether. The appellant owned a worldwide business for the manufacture of guns and ammunition, which he sold to the respondent. The appellant covenanted that he would not engage *inter alia* in the trade of manufacturing guns or carriages for 25 years. The covenant was unrestricted as to space. The appellant argued that the covenant was universal and hence unenforceable.

The House of Lords disagreed. Lord Herschell L.C. pointed out that modern businesses and communications were so much more sophisticated that it was no longer possible to state categorically that a general restraint was unreasonable, nor that its universality was reason enough to refuse to enforce it. Lord Watson set out the general rule as follows:

> I think it is now generally conceded that it is to the advantage of the public to allow a trader who has established a lucrative business to dispose of it to a successor by whom it may be efficiently carried on. That object could not be accomplished if, upon the score of public policy, the law reserved to the seller an absolute and indefeasible right to start a rival concern the day after he sold. Accordingly it has been determined judicially that in cases where the purchaser, for his own protection, obtains an obligation restraining the seller from competing with him within bounds which having regard to the nature of the business, are reasonable and are limited in respect of space the obligation is not obnoxious to public policy, and is therefore capable of being enforced.

Lord Watson, together with Lords Ashbourne, McNaughten and Morris, concluded that the only true question was whether in the circumstances of the case the restraint was reasonable.

B. The Current Law

1. Generally

The approach to covenants in restraint of trade adopted by the House of Lords in *Nordenfelt* has been persuasive in Canada. In the recent Supreme Court of Canada case of *Elsley et al.* v. *J.G. Collins Insurance Agencies Ltd.*, Dickson J. *per curia* stated:

> The principles to be applied in considering restrictive covenants of employment are well established. They are found in the cases above mentioned and in such familiar authorities as the *Nordenfelt* case, ... 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. In assessing the opposing interests the word one finds repeated throughout the cases is the word "reasonable." The test of reasonableness can be applied, however, only in the peculiar circumstances of the particular case. Circumstances are of infinite variety. Other cases may help in enunciating broad general principles but are otherwise of little assistance.
>
> It is important, I think, to resist the inclination to lift a restrictive covenant out of an employment agreement and examine it in a disembodied manner as if it were some strange scientific specimen under microscopic scrutiny. The validity or otherwise of a restrictive covenant can be determined only upon an overall assessment of the clause, the agreement within which it is found and all of the surrounding circumstances.

The general approach of the courts to covenants in restraint of trade was, until recently, regarded as well settled. The issues in a litigated case will usually not turn on the content of the general rule, which has been considered and applied in so many cases that it may fairly be said to have assumed the status of trite law., (1981) 28 Nfld. & P.E.I.R. 377, 79 A.P.R. 377 (P.E.I. S.C.).

While the test of reasonableness as the *sine qua non* of enforceability is well entrenched in the common law, courts in England and Canada have recently begun to question the content of that test. Traditionally the rule of reasonableness was thought to invite an examination of the economic impact of the agreement in restraint of trade on the parties and on the public. However, in recent cases, the presentation of complicated expert evidence on the economic impact of a covenant in restraint of trade has induced courts to embark on a restatement of the test of reasonableness. We shall examine the requirement of reasonableness later in this Report.

It is pertinent to note that the same rules apply whether the restraint is framed in terms of geography, time, or even in respect of clients who may not be solicited. A covenant that an employee shall not contact any person who ever made an inquiry of his employer attracts the general rule invalidating unreasonable restraints of trade as surely as a covenant that the employee shall not exercise his trade in Canada. Some covenantees will bargain for a covenant in restraint of trade which combines all three restrictions. A covenant may provide, for example, that a salesman not contact any clients resident in Vancouver for three years after the termination of his employment.

However, a bald statement that the courts will never enforce unreasonable covenants in restraint of trade would be misleading. Courts have often expressed the view that *prima facie* it is important that people be held to their bargains. Moreover, the effect of refusing to enforce a covenant may be to strip the plaintiff of the protection for which he bargained and leave him to his rights at common law, even though the overreaching was an innocent miscalculation and even though consideration for the covenant may already have passed. As a result, the courts have on occasion sought to evade the application of the general rule.

First, as a matter of construction courts will judge the reasonableness of a covenant in the light of the probable consequences of its application. The reasonableness of a covenant is judged as at the time it was entered into, and it will not be termed "unreasonable" merely because if applied to facts which will probably never occur the result might be undesirable. In *Greening Industries Ltd.* v. *Penny*, Bissett J. stated:

> It is contended, of course, that the covenant is too wide in scope in that it would prevent the Pennys from holding one share in a business engaged in a competitive or similar business with that of Adamson Ropes, although there might be thousands of shareholders and also being employed by such a competitor and "that it would prevent the Pennys from taking life insurance in a company which held shares in a company that was engaged in a business similar or competitive with the business presently carried on by Adamson Ropes."
>
> I do not think this covenant can be tested by such extreme situations which may never arise, and I think there is judicial authority to support this view of the matter.

Second, Canadian courts have been willing to sever portions of offending covenants by application of the "blue pencil" test. If it is technically possible to delete certain words in a covenant and leave a grammatical and economically feasible arrangement not in itself unreasonable, and if an intent to adopt such restrictions could fairly be imputed to the parties, then the courts have the power, by deleting offensive words, to enforce the covenant to the extent that it is reasonable.

Courts may sever the whole or a part of a covenant in restraint of trade whether the contract expressly so provides or not. Where no express provision is contained in the covenant, the court will carefully examine the agreement. In *T.S. Taylor Machinery Co. Ltd.* v. *Biggar*, the defendant had agreed to a fairly onerous covenant, part of which provided:

> If the sales manager shall resign from the company, he shall not within five years of such resignation and/or without written consent of the managing director of the company:
>
> a) work in any capacity whatsoever in any province in Canada where the company is transacting business for either
>
> i) any of the company's principals, or
> ii) any other person, firm or company that the company has had during the term written negotiations to act as agents for;
>
> b) within Alberta, Saskatchewan, Manitoba and Ontario,
>
> i) sell, handle or deal in any of the lines,
> ii) carry on or be concerned or interested in carrying on any business similar to the business carried on by the company during the term;
>
> unless the sales manager shall pay to the company the sum of ten thousand ($10,000.00) dollars as liquidated damages or such greater amount as the court may allow.

Dickson J.A. declined to sever any of the provisions:

> I would hold, therefore, that the covenant as it stands is in restraint of trade, unreasonable and unenforceable at law.
>
> In certain circumstances an agreement in restraint of trade which is in part reasonable and in part unreasonable may be severed and the part which is reasonable enforced. The conditions under which severance will be permitted in an employeremployee agreement are strictly limited. The severed parts must be independent of one another; the excess to be severed must not be part of the main purport of the clause. The severance necessary here would offend both of these conditions. It would so emasculate the covenant as to leave nothing recognizable. The Court will not rewrite the covenant.

By way of contrast, in *Furlong* v. *Burns & Co. Ltd*., Hughes J. of the Ontario High Court was prepared to sever those elements of the contract which constituted an unreasonable restraint of trade. The defendant desired that the plaintiff withdraw from its employ, and a settlement was arrived at under which the plaintiff was to be paid $50,000 and retain his pension rights. The agreement contained the following clause:

> 3. Allowance to be continued at the discretion of the Company subject to your attitude and conduct not being, in the opinion of the executive of the Company, detrimental to the company or its personnel.

The company sought to avoid its obligations on the ground that the plaintiff had taken employment with a competing firm. However, Hughes J. held that if it were so applied, the condition would constitute an unreasonable restraint of trade which could be severed from the balance of the settlement:

> The question here is: can paragraph 3 ... together with the references to it in paras. 4 and 6, be removed, leaving substantial consideration for the promise to pay the allowance? Certainly the main consideration moving from the promisee to the promisor was the resignation and quite sufficient in my view to support a not extravagant monetary payment to a senior official of a large corporation whose ability as an employee was not in doubt.

The "blue pencil" test depends upon the presence of severable words in the body of a covenant. Courts in Canada have disclaimed any power to enforce in part a covenant in restraint of trade by rewriting it. For example, a covenant not to compete in British Columbia will not be enforced only in respect of proposed activities in Vancouver. However, a covenant of similar import may be partially enforced by severance if framed differently. If the covenant was framed so that the undertaking was not to compete in "a) Vancouver and b) the rest of British Columbia," a court might readily "blue pencil" the words "and b) the rest of British Columbia."

In our *Report on Illegal Transactions* we considered the law governing severance of illegal covenants in some detail. In that Report, the power to sever was reformulated by deleting any reference to the "blue pencil" test, which we considered unduly formalistic and arbitrary. The recommendations made in that Report included one whereby the court was empowered to make an order that "certain rights or obligations arising out of the illegal transaction are not binding on the parties and that the remainder of the rights and obligations constitute a binding and enforceable transaction." This amounts to a power of severance divorced from the "bluepencil" test.

American courts have taken a more flexible attitude towards the partial enforcement of covenants in restraint of trade than AngloCanadian courts. As J.G. Grody noted in a recent article:

> If the contractual restraint operates for too long, over an excessive territory or with respect to an unreasonable range of activities, the court may pare down its terms and enforce the ... promise within reasonable limits.

This partial enforcement rule does not depend upon any "blue pencil" test or upon the severability of certain terms in the covenant. It is in effect a jurisdiction to impose upon the parties a reasonable covenant in substitution for the unreasonable one contained in the agreement. In *Solari Indus. Inc*. v. *Malady*, a New Jersey decision, it was stated that even where a covenant is unreasonable an employer is entitled:

> ... to that limited measure of relief within the terms of the noncompetitive agreement which is reasonably necessary to protect [its] legitimate interests, will cause no undue hardship on the [employee] and will not impair the public interest.

In the *Solari* case the defendant, a salesman of electronic equipment, covenanted not to compete with the plaintiff for one year following his employment, without territorial limitation. Subsequently the defendant obtained a competing franchise and went into business. At trial the plaintiff failed to obtain an injunction on the ground that a statewide covenant was unreasonable. However, on appeal that view was rejected. The New Jersey Court of Appeal was of the view that the rules respecting severance led to "tortuous interpretations and incongruous differentiations." As a result the court was willing to enter into an inquiry respecting the extent of a reasonable covenant and to issue an injunction accordingly.

The assertion of such a jurisdiction by American courts has been accompanied by controversy. The acceptance of a power to rewrite contracts to provide for reasonable restraints has been examined in a number of American articles. Nevertheless, some 17 American jurisdictions have adopted a rule permitting the rewriting of covenants without reference to the "blue pencil" test of severability.

Idaho: *Insurance Center Inc*. v. *Taylor*, (1972) 94 Idaho 896, 499 P. 2d 1252.
Iowa: *Ehlers* v. *Iowa Warehouse Co.*, (1971) 188 N.W. 2d 368, Mod. on other grounds 190 N.W. 2d 413.
Kansas: *Foltz* v. *Struxness*, (1950) 168 Kan. 714, 215 P. 2d 133.
Kentucky: *Ceresia* v. *Mitchell*, (1951) 242 S.W.2d 359.
Maryland: *American Weekly, Inc*. v. *Patterson*, (1940) 179 Md. 109, 16 A. 2d 912 (*see John Rosne Inc*. v. *Tweed, supra*.

Minnesota: *Bess* v. *Bothman*, (1977) 257 N.W.2d 791.
Mississippi: *Redd Pest Control Co.* v. *Heatherly*, (1963) 248 Miss. 34, 157 So. 2d 133.
Missouri: *R.E. Harrington Inc*. v. *Frick*, (1968) 428 S.W. 2d 945.
New Jersey: *Solari Industries, Inc*. v. *Malady*, (1970) 264 A. 2d 53.
North Dakota: *Igoe* v. *Atlas ReadyMix, Inc*., (1965) 134 N.W. 2d 511.
Ohio: *Raimonde* v. *Van Vlerah*, (1975) 325 N.E. 2d 544.
Oklahoma: *Wesley* v. *Chandler*, (1931) 3 P. 2d 720.
Texas: *McAnally* v. *Person*, (1933) 57 S.W. 2d 945; *Grace* v. *Orkin Exterminating Co.*, (1953) 255 S.W. 2d 279.
Washington: *Wood* v. *May*, (1963) 438 P. 2d 587.
West Virginia: *Reddy* v. *Community Health Foundation of Man*, (1982) 298 S.E. 2d 906.
Wisconsin: *Fullerton Lumber Co.* v. *Torborg*, (1955) 70 N.W. 2d 585. We shall examine the issues surrounding partial enforcement of covenants in restraint of trade later in this paper when we consider whether the present rule should be modified.

The artificiality of the rules respecting severance combined with the possibility of unjust results which might occur where a covenant is struck down have led some Canadian courts to take a flexible approach to unreasonable covenants in restraint of trade, even while affirming the general rule that the court should not rewrite the contract between the parties. In *Betz Laboratories Ltd.* v. *Klyn*, the defendant had agreed not to engage in any field of endeavour competitive with the plaintiff anywhere in British Columbia. Ruttan J. issued an interlocutory injunction which restricted the defendant only from acting as a salesman, even though the covenant was framed in much wider terms. He recognized that severance was only available if the severed parts were independent of that which remained. He concluded, however, that to grant an injunction in terms that were narrower than the covenant did not constitute "emasculating" or rewriting the covenant.

> ... in the present circumstances to restrict the covenant as I have indicated is not to emasculate it. The trial judge may still widen or narrow the scope of the covenant depending on the evidence adduced.

This case may be readily explained as turning on the courts' reluctance to prejudice the defendant's position on an application for an interlocutory injunction. Ruttan J. has, however, also expressed dissatisfaction with the rigidity of the general rule in other cases. In *Maxwell* v. *Gibsons Drugs Ltd.*, for example, Ruttan J. granted the parties to the action time to modify the covenant:

> At the trial counsel agreed that the restrictive covenant covered too large an area, and that this was an error which could be rectified. The 25mile radius tends to impinge upon parts of West Vancouver and such was never the intention. I am sure counsel can together agree on a narrower area which will cover only the peninsula including Sechelt and Gibsons.

In a recent case, Ruttan J. asserted an equitable jurisdiction whose exercise involved, in effect, rewriting a restrictive covenant. In *Nili Holdings Limited* v. *Rose*, the plaintiff operated a restaurant in Victoria, British Columbia. It sought an injunction to restrain the defendant, a talented jazz singer, from performing anywhere south of Duncan for two years, except in the plaintiff's restaurant. The covenant was part of an agreement under which the defendant was released from her contractual obligation to sing in the plaintiff's restaurant lounge. Ruttan J. held that the covenant was reasonable in the circumstances of the case at the time it was made. Nevertheless he refused to continue an interim injunction:

> When the parties agreed to the restrictive covenant in August 1980, the restriction was not unreasonable either from a public or private nature, and it was properly enforceable to protect the proprietary rights of the plaintiff. I find with respect that the interim injunction granted by my brother Bouck was fair and justified at the time it was granted. However, continued enforcement of that injunction works too harsh a burden economically and socially on the defendant and I have decided to reduce the time limit on the restrictive covenant by the amount of the final year. I therefore direct that the injunction be not continued, and be terminated as of today's date, and the restrictive covenant expire at the same time.

The assertion of a jurisdiction to reduce the term of the covenant is a novel one, although it is undoubted that the court has an equitable jurisdiction to refuse an injunction if it would operate inequitably. In such a case the court may award damages in lieu of an injunction. Although Ruttan J. was not "disposed" to make a further order respecting damages at the time the injunction was dissolved, he did indi-

cate that he would be prepared to assess damages in the future. It is not clear that the damages to be assessed related to the final year in which the covenant was to be in force. If the term of the covenant was to "expire" as Ruttan J. directed, the defendant would not be in breach of the covenant if she ignored its strictures, and hence there would be no damages to assess after that date.

These cases stand apart from the general law with respect to covenants in restraint of trade. Canadian courts have, for the most part, firmly rejected any power to modify a covenant to conform to the judge's view of what would be reasonable in the circumstances. Accordingly, in *Investors Syndicate Ltd.* v. *Versatile Investments et al.*, Reid J.refused to enforce an overly broad covenant by awarding damages for only certain breaches:

> I hold further that although Investors seeks relief in narrower terms than occur in s. 17 that does not narrow the scope of the section. The issue of reasonableness must depend upon the wording of the provision; it cannot depend upon a narrower application of the provision sought by one seeking its advantage.
>
> Mr. Roland was at pains to point out that the injunction he seeks is not against all solicitation by defendants of Investors' clients. It is only, he says, solicitation for the purpose of inducing Investors' clients to give up their investments in Investors' vehicles in favour of those offered by Versatile that he seeks to prevent. Thus, he says he would leave defendants free to solicit "new business", *i.e.*, investment that would not involve the termination of investments in Investors' vehicles.
>
> If Mr. Roland's proposal is made to escape the consequences of a restrictive covenant having been cast in terms that might be too wide it seems to me to be something that cannot be done. If a restrictive covenant prohibited one party to a contract from competing with the other "throughout Canada" would it be an answer to the charge that the provision is too broad to say that "in this lawsuit we merely seek to prevent his working in Ontario"? If that could be done there would be no reason why another suit should not be launched in another Province with the relief requested again confined to that particular Province. In that way the "geographic extent" of a restrictive covenant would never be tested for it would never, as written, be in issue. Yet surely the question whether the provision as it appears in the context of an agreement is lawful is the issue. To approach it as Mr. Roland suggests would be to substitute the issue of the extent of the relief requested for the issue of the extent of the covenant. Mr. Roland's approach, in my opinion, begs the real question and I must reject it. My concern, therefore, is the proper interpretation of s. 17 in the context of the agreement and the relevant circumstances.

2. Which Contracts are Caught by the General Rule?

(a) Generally

In some jurisdictions, it is considered that the mobility of the labour force is a matter of such high public concern that no contractual restraint, however reasonable, should be enforced. This is particularly so in those jurisdictions which have adopted the Field Code, of which California is one. The California *Business and Professional Code* provides in paragraph 16600:

> *Invalidity of contracts*: Except as provided in this chapter, every contract by which anyone is restrained from engaging in a lawful profession, trade or business of any kind is to that extent void.

The exceptions to this general rule are limited to covenants binding the vendor of good will (paragraph 16601) and partners on the dissolution of a partnership (paragraph 16602).

In British Columbia only one particular kind of contract in restraint of trade has been expressly forbidden by legislation. Section 94 of the *Medical Practitioners Act* provides:

> 94. A covenant or provision in an agreement made or entered into by a member of the College after April 17, 1973, and to the effect that the member will not practise medicine in the Province for a specified period of time, in a specified location, or in a specified field of medicine, is void.

Enactment of this section was prompted by the controversy generated by the case of *Green* v. *Stanton*, in which a doctor was held to be bound by his covenant not to practise within ten miles of Cranbrook.

Several types of contracts customarily contain covenants in restraint of trade. Employment contracts are obvious examples, as are agreements respecting the sale of a business in which the vendor covenants not to compete. The object of the latter clause is to give the new purchaser a reasonable chance to supplant the vendor in the minds of the business's customers, thereby preserving the goodwill of the business he purchased.

It would, however, be a gross oversimplification to assume that the issues raised by these two types of covenants are identical. Although the same general rule applies, courts are more reluctant to enforce a restrictive covenant contained in an employment contract than one contained in a contract for the sale of a business. In *Elsley* v. *J.G. Collins Insurance Agencies Ltd.*, Dickson J. stated:

> The distinction made in the cases between a restrictive covenant contained in an agreement for the sale of a business and one contained in a contract of employment is wellconceived and responsive to practical considerations. A person seeking to sell his business might find himself with an unsaleable commodity if denied the right to assure the purchaser that he, the vendor, would not later enter into competition. Difficulty lies in definition of the time during which, and the area within which, the noncompetitive covenant is to operate, but if these are reasonable, the Courts will normally give effect to the covenant.
>
> A different situation, at least in theory, obtains in the negotiation of a contract of employment where an imbalance of bargaining power may lead to oppression and a denial of the right of the employee to exploit, following termination of employment, in the public interest and in his own interest, knowledge and skills obtained during employment. Again a distinction is made. Although blanket restraints on freedom to compete are generally held unenforceable, the Courts have recognized and afforded reasonable protection to trade secrets, confidential information, and trade connections of the employer.

Canadian courts have been astute in characterizing certain arrangements as being in restraint of trade. They will look to the substance of the scheme and not to its form. Hence an agreement that a partner who went into business for himself within a radius of twenty miles and within two years of the dissolution of the partnership was to receive only $1.00 in respect of his partnership interest was *prima facie* in restraint of trade, as was a bond executed in support of a noncompetition clause, and a stipulation that certain payments were subject to the recipient's conduct not being detrimental to the payor's interests invoked to prevent the recipient from taking employment elsewhere. A requirement that training expenses be repaid should the employee leave, as well as a stipulation that commissions due and owing should not be paid if a salesman took employment elsewhere, have also been held to be in restraint of trade.

There are two particular types of contracts which require more detailed examination. Both types of contracts deal with the consensual organization of the marketplace. These contracts may be characterized as "vertical" and "horizontal" restraints. The application of the general rule to these types of cases is not straightforward as in other cases.

A "vertical" restraint is one agreed to by parties occupying different positions in an industry. For example, a manufacturer of a product (say, widgets) may wish to ensure its orderly and continuing retail distribution. He may do so by entering into an agreement with a retailer obliging him to purchase a certain quantity of widgets in a given period exclusively from the manufacturer. Generally, such an arrangement will prohibit the retailer from selling widgets made by any other manufacturer. Such "vertical" restraints are often called "solus" agreements, and the clauses requiring faithful adherence to the manufacturer's widgets are known as "tying" covenants. Contracts between garage owners and major oil companies, between brewer and publican, and franchisor and franchisee often take the form of solus agreements. Particular problems have arisen recently in Commonwealth courts concerning the application of the doctrine of restraint of trade to "vertical" restraints.

In contrast, an "horizontal" restraint is one by which persons occupying a similar position in an industry bind themselves to regulate it in a certain manner. For example, an agreement between bottlers of soda pop dividing up the local market between themselves would constitute an "horizontal" restraint. Such agreements may result in the creation of a cartel. As such, horizontal restraints may result not only

in invalidation by reason of the application of the doctrine of restraint of trade, but also by reason of the *Combines Investigation Act*. That Act governs in part the consensual regulation of the marketplace.

Horizontal restraints are more obvious examples of contracts which may be unenforceable as in restraint of trade, and contrary to the *Combines Investigation Act*. Recent authority indicates that courts will probably look with disfavour upon practices which, although they may not infringe that Act, nevertheless constitute a restraint of trade. Courts have condemned agreements respecting the employment of the exemployees of competing businesses, league rules respecting the transfer of players and ethical rules promulgated by a pharmaceutical society which would have restricted the nature of goods sold in chemists' shops.

(b) Solus Agreements

"Vertical" restraints are becoming increasingly common. The popularity of fast food restaurants and businesses dealing with automobile servicing has led to the formulation of complicated franchising agreements. A successful business may take advantage of its good will by selling the right to use its name and deal in products bearing its cachet. Frequently the franchisor in consideration of the transfer of the goods and the application of its managerial and marketing expertise, together with the right to use its products, will insist on a covenant requiring the franchisee to purchase all or a portion of the goods it requires for resale from the franchisor. This type of covenant is a typical "vertical restraint," and the covenants tying franchisee to franchisor are often termed a "solus agreement." Vertical restraints may also infringe the *Combines Investigation Act*. We shall examine the effect of this Act in greater detail later in this Report.

The increasing use of solus agreements in retailing, and particularly in the petroleum industry, has given rise to a good deal of litigation in Canadian and Commonwealth courts. A clause tying a subservient party to a dominant party in respect of the purchase of goods required for resale, or the use of certain trading names, has an obvious capacity to restrain the ability of the subservient party to trade. There is, accordingly, a large body of jurisprudence concerning solus agreements and the doctrine of restraint of trade. Moreover, covenants restraining the ability of a subservient party to trade with whomever he wishes often touch and concern land. As a result, principles of the law governing real property have become inextricably interwoven with questions governing the validity of covenants contained in a solus agreement.

The earliest cases on solus agreements concerned restraints placed by brewers upon publicans. These restraints usually obliged the publican to purchase beer only from the brewer concerned, and were often contained in mortgages and leases. On occasion, the covenants were in gross.Two issues fell to be decided in the early English cases. The first concerned the enforceability of covenants restricting the purchase of beer as between the successors in title to the interests of the brewer and publican. It was early settled that the covenants ran with the land, and hence were enforceable by and against successors in title to the original parties. These early decisions were followed in Canada by the New Brunswick Court of Appeal in *Memramcook Transport Ltd.* v. *Irving Oil*.

However, the mere fact that a person purchased a pub and was bound in theory by the covenants which ran with the land was not originally regarded as preventing any reference to the doctrine of restraint of trade. In fact, the inquiry in these cases was regarded as a two step process. The first question was whether the covenant ran with the land so as to bind the defendant, and the second question was even if it did, whether it was unenforceable as an unreasonable restraint of trade.

A number of Canadian cases decided prior to 1960 discuss the question of the enforceability of solus agreements between the original parties thereto. These cases proceed on the basis that the doctrine of restraint of trade applied to solus agreements notwithstanding that the restraints were directly concerned with the use made of a particular parcel of land.

The decision of the English Court of Appeal in *Petrofina (Great Britain) Ltd.* v. *Marten and Another*, marks the beginning of the modern challenge to the applicability of the restraint of trade doctrine to solus agreements. In that case, Petrofina claimed an injunction restraining the defendants from breaching those terms of a legal charge granted to Petrofina by the defendant's predecessors in title to secure repayment of an advance of money to assist those predecessors to purchase the garage site. The charge, as well as a separate collateral agreement, contained clauses prohibiting the defendant from buying any motor fuel or other petroleum products which he might require at the garage. In return, Petrofina agreed to assist in the running of the premises with a view to the promotion of sales and the supply of such goods as might be required. At trial, the trial court judge held that Petrofina was not entitled to protect itself from competition *per se.* The covenant was an unreasonable restraint of trade and was therefore unenforceable. It constituted a mere covenant in gross to purchase petrol exclusively from Petrofina.

Lord Denning M.R. on appeal rejected the contention that solus agreements were not subject to the doctrine of restraint of trade. In so holding, he relied heavily on the brewery cases. Counsel's second argument was that the doctrine of restraint of trade had no application to a restriction of whatever nature imposed on a particular piece of land, as opposed to a restriction imposed on a person or corporation. It should be noted that in the brewery cases, this argument had not succeeded. Nor did it succeed before the Court of Appeal. Lord Denning M.R. rejected the contention, distinguishing cases in which restrictions are placed on the use to which lands are to be put, and to which the doctrine of restraint of trade had no application, from cases involving covenants which restrict a trademan in the manner in which he can carry on a trade on his own land. The latter are more properly characterized as matters of contract to which the doctrine of restraint of trade applies. The burden lay upon Petrofina to show that the covenant was reasonable, which it had failed to do. Lord Denning M.R. stated in his judgment that there were no particular
categories of restraint to which the doctrine of restraint of trade did not apply.

Diplock L.J. agreed that the covenant in issue was a bare contract unassociated with any interest of the oil company in the land on which the filling station was situate. In that context, Diplock L.J. held:

> Exclusive merchanting agreements between a manufacturer and a wholesaler under which the latter agrees to purchase his requirements of a particular class of goods exclusively from the former and to sell no other goods of that class are common enough. They come, however, within the category of contracts in restraint of trade, and such of their terms as restrict the wholesaler's liberty to carry on trade in goods of that class with other persons not parties to the contract are enforceable only in so far as they afford no more than adequate protection to an interest of the manufacturer which he has a right to have protected.

Lord Diplock went on to deal with the argument that the doctrine of restraint of trade had no application to restrictions on the use to be made of a particular piece of land. He distinguished the *Petrofina* case from those cases which might involve leases, conveyances of land or mortgages, and expressly stated that he was not purporting to decide the case of a covenantor who at the time of the agreement had not yet acquired any interest in land from which the business was to be carried out. He accordingly did not deal with the argument that the doctrine of restraint of trade did not apply to covenants governing the use to be made of a particular piece of land. Nor did he consider it necessary to consider the question of whether or not the covenants in issue ran with the land, and the relationship between the doctrine of covenants running with the land and the doctrine of restraint of trade.

Accordingly, in the case of *Esso Petroleum Ltd.* v.*Harpers Garage (Stourport) Ltd*. the question of the relationship between the doctrine of restraint of trade and the rules governing covenants binding a particular piece of land was again raised in argument before the House of Lords. In that case, Esso Petroleum Co. Ltd. had been granted a mortgage by the respondent, the terms of which obliged the mortgagors to purchase exclusively from it all motor fuels required for consumption or sale on the premises. The appellant declined to abide by the terms of the mortgage or the sales agreement when lower priced petrol came on to the market.

Counsel for the respondent argued firstly that restrictive covenants affecting land and imposing a burden on it rather than a particular person were not subject to the doctrine of restraint of trade. Assuming that the doctrine of restraint of trade applied to the mortgage, counsel then argued that it was reasonable in the interest of parties.

Lord Reid noted counsel's argument that the doctrine of restraint of trade should not apply to restrictions on the use to be made to a particular piece of land, holding:

> The main argument submitted for the appellant in this matter was that restraint of trade means a personal restraint and does not apply to a restraint on the use of a particular piece of land. Otherwise it was said, every covenant running with the land which prevents its use for all or for some trading purposes would be a covenant in restraint of trade and therefore unenforceable unless it could be shown to be reasonable and for the protection of some legitimate interest.

Lord Reid was therefore faced with the delicate problem of defining the proper ambit of the general rule governing covenants in restraint of trade in a manner which would not upset the well established view that covenants restricting the use of land were valid and enforceable. He held that it was not possible to define the proper ambit of the general rule in narrow, technical terms, stating:

> It was said that the present agreement only prevents a sale of petrol from other suppliers in the site of the Mustow Green Garage: it leaves the respondents free to trade anywhere else in any way they choose. But in many cases a trader trading at a particular place does not have the resources to enable him to begin trading elsewhere as well, and if he did he might find it difficult to find another suitable garage for sale or to get planning permission to open a new filling station on another site. As a whole the doctrine of restraint of trade is based on public policy its application ought to depend less on legal niceties or theoretical possibilities than on the practical effect of a restraint in hampering the freedom which it is the policy of the law to protect.
>
> It is true that it would be an innovation to hold that ordinary negative covenants preventing the use of a particular site for trading of all kinds or of a particular kind are within the scope of the doctrine of restraint of trade. I do not think that they are. Restraint of trade appears to me to imply that a man contracts to give up some freedom which otherwise he would have had. A person buying or leasing land had no previous right to be there at all, let alone to trade there, and when he takes possession of that land subject to a negative restrictive covenant, he gives up no right or freedom which he previously had ... In the present case the respondents before they made this agreement were entitled to use this land in any lawful way they chose, and by making this agreement they agreed to restrict their right by giving up their right to sell there petrol not supplied by the appellants.

It is therefore evident that Lord Reid was of the view that a person who accepts a piece of land with a preexisting restraint on it does not restrict his trading freedom, since he is free to reject the land and to go elsewhere. However, a person who possesses an unfettered right to trade in a particular piece of land for all practical purposes restricts his ability to trade when he accepts restrictions on the use of the land.

This distinction was also adopted by Lord Hodson, who held:

> All dealings with land are not in the same category; the purchaser of land who promises not to deal with the land he buys in a particular way is not derogating from any right he has, but is acquiring a new right by virtue of his purchase. The same consideration may apply to a lessee who accepts restraints upon his use of land; on the other hand, if you subject yourself to restrictions as to the use to be made of your own land so that you can no longer do what you were doing before, you are restraining trade and there is no reason why the doctrine should not apply.
>
> It is difficult to devise a formula relating to land which covers all cases in which the doctrine should be excluded. Counsel for the respondents submitted that the solution might be that the doctrine only applied to covenants for the benefit of the trade of the covenantee which either forbids the covenantor to carry on his trade or restricts the manner in which he does so. This solution serves the property cases to which I have referred where restrictive covenants are given to protect property, not trade, but as was pointed out in argument, does itself lead to anomalies and practices between one property and another.

Lord Wilberforce was also of the view that the determination of whether or not the doctrine of restraint of trade applied to a particular type or category of contract was one to be made on pragmatic grounds:

> But the development of law does seem to show that judges have been able to dispense from the necessity of justification under a public policy test of reasonableness such contracts or provisions of contracts as, under contemporary conditions, may be found to have passed into the accepted or normal currency of commercial or contractual or conveyancing relations [because] ... moulded under the pressures of negotiation, competition and public opinion, they have assumed a form which satifies the test of public policy as assumed by the courts at the time, or ... the trade in question has assumed such a form that for its health or expansion it requires a degree of regulation. Absolute exemption for restriction or regulation is never obtained: circumstances, social or economic, may have altered since they obtained acceptance, in such a way as to call for a fresh examination: there may be some exorbitance or special feature in the individual contract which takes it out of the accepted category: but the curt must be persuaded of this before it calls upon the relevant party to justify a contract of this kind.

Lord Wilberforce's judgment requires a pragmatic assessment of the marketplace, rather than the more formalistic test proposed by judges in other cases. It is a view which finds some support in British Columbia. In *Canadian Pacific Navigation Co.* v. *Victoria Packing Co.*, Begbie C.J. B.C. expressed the view that although some limits should be imposed on the restraint of trade doctrine, the court should not lose sight of economic realities:

> It is clear there must be some prescribed limits of restraint, otherwise scarcely any agreement between traders would stand. For every agreement involves an obligation, sometimes many obligations; and every obligation involves a restraint between traders, generally a restraint of trade. But every marriage is, in a sense, a contract in restraint of marriage. The parties may intermarry with nobody else. Every contract of partnership, nay every contract of sale, is a contract, in a sense, in restraint of trade.

The decision of the House of Lords in the *Esso Petroleum* case and, in particular, the drawing of a distinction between contracts imposed on land the property of a trader at the time the restriction is imposed, and covenants imposed on land not the property of a trader which was acquired subject to a restraint, can be criticized on several grounds. For example, the notion that the doctrine of restraint of trade does not apply where a trader comes to a restriction is in effect a revival of the discredited notion derived from the case of *Tulk* v. *Moxhay* that courts of equity would enforce covenants restricting the use of land even where there was no dominant tenement to be benefitted by it, if the person who took the land did so with notice of the restriction.

Moreover, it was never thought in the brewery cases that the operation of the doctrine of restraint of trade was excluded merely because the publican's successor in title "came to the restriction." In such cases, two arguments were invoked; the first that there was no notice of the restriction, and the second that the restriction was in any event in restraint of trade. The House of Lords accordingly revived an old doctrine concerning the enforceability of covenants binding land, without the limitations which formerly attended its use.

As Haydon has noted in his book, it is possible to construct any agreement so that it could fairly be argued that a trader "came to" a restriction. One such scheme would involve a lease to the covenantee and a leaseback to the covenantor, who then acquires the lease subject to the restrictive covenant. However, although it has been held in England that a lease and leaseback in such a case is not a sham in that it gives the oil company protection by way of lease which it can otherwise obtain, in subsequent cases, courts in Australia and in England have declined to accept the loss of possession by the original owner for a mere "scintilla of time" as excluding the doctrine of restraint of trade by reason of any argument that the original owner had "come to the restriction." In *Amoco Australia Pty. Ltd.* v. *Rocca Brothers Motor Engineering Co. Pty. Ltd.*, Rocca Brothers had granted the lease of land to Amoco, who in turn granted a sublease back to Rocca containing restrictive covenants respecting the purchase of petrol and related products. The Australian High Court declined to characterize *Rocca Brothers* as having acquired the land subject to the restraint, and held that the case was better considered as one in which an owner of land had fettered his pre existing freedom to trade from it.

It would seem that in England the rule that the doctrine of restraint of trade does not apply to persons who come to a restraint is well settled. It was applied on an appeal from an interlocutory injunction by the English Court of Appeal in the case of *Cleveland Petroleum Co. Ltd.* v. *Dartstone Ltd. and Another*. In the recent case of *Alec Lobb (Garages) Ltd. and Others* v. *Total Oil Great Britain Ltd*., it was applied by Peter Millett, Q.C., sitting as a deputy High Court judge. In that case, counsel mounted a direct assault on the distinction between a businessman who imposes a restriction on trading from his own land, and one who comes to a restriction. Peter Millet, Q.C. held:

> I cannot accept Mr. Peppitt's argument that the result is absurd, for what he calls an absurdity seems to me to be inherent in the approach of the House of Lords in *Esso Petroleum Co. Ltd.* v. *Harper's Garage (Stourport) Ltd.* Granted the premise, by which I am bound, I am compelled to conclude that an estate owner is free to deprive himself altogether of the right to trade from his land, forever or for a limited period, by parting with the land; but he is not free to retain his land or present interest in it and at the same time unduly restrict his right to trade from it.

He went on to consider the facts of the case, in which it was sought to enforce against the personal plaintiffs, Mr. and Mrs. Lobb, covenants given by their closely held company. It was argued that the corporate veil should be pierced and Mr. and Mrs. Lobb treated in the same fashion as if they had been the original owner of the land, rather than their closely held company. As Peter Millet, Q.C. pointed out, in the *Esso Petroleum Co. Ltd*. itself the premises had originally been owned by personal defendants, who had transferred the land to their own closely held company for the purposes of the transaction. In that case, the House of Lords proceeded without argument on the basis that the personal and corporate defendants were both liable on the covenant. Peter Millet, Q.C. concluded:

> I have not found this an easy question. I have difficulty in discerning the particular feature of public policy which allows a 21year tie to be included in a lease to anyone else, but not in a leaseback to the original estate owner; or which allows an estate owner to part with all right to trade from his land by disposing of his land, but not to part with the one while retaining the other. As a result, I have a similar difficulty in understanding why the public interest should require the plaintiff company to part altogether with its land and business and deny Mr. and Mrs. Lobb the harmless subterfuge by which they were able to retain their livelihood. But it seems to me all these consequences are inherent in the approach of the majority of their Lordships in *Esso Petroleum Co. Ltd*. v. *Harper's Garage (Stourport) Ltd*. [1968] A.C. 269. Given that the doctrine of restraint of trade applies to a sale and leaseback to the original estate owner, its application cannot in my judgment be circumvented by a transparent device adopted for the purpose. Public policy is concerned with matters of substance and reality; and the substance and reality of the present transaction was that the plaintiff company raised finance on its land, but by a lease and leaseback rather than by a mortgage; and that the business continued to be carried on by and for the benefit of the same persons as before. The ownership of the site passed from the company to Mr. and Mrs. Lobb; but the tie was not imposed in the course of the change of ownership; the change of ownership was effected in order to bolster the tie. In these circumstances, I conclude that the doctrine of restraint of trade applies to this underlease, with the result that the tie is invalid.

The application of the doctrine respecting restraint of trade and its application to solus agreements governing the use of land remains unsettled in Canada. Only three Canadian cases go so far as the *Cleveland Petroleum and Alec Lobb Ltd*. cases to apply Lord Reid's dictum respecting the limits on the applicability of restraint of trade. There are in fact, very few Canadian cases dealing with the principles set out in the modern English cases.

One line of Canadian authority is concerned with the effect of solus agreements contained in mortgages. In *Re Moore* v. *Texaco Canada Ltd*., Grant J., of the Ontario High Court, considered an argument that the agreement constituted a clog on the mortgagor's equity of redemption. In this case, the covenantor had purchased certain property from the oil company by way of an agreement which provided for a solus agreement with a term of 25 years. The clause was expressly agreed to run with the land. The covenantor also applied to the oil company for a mortgage which on the oil company's insistence itself contained a solus agreement. The sale was duly closed by a deed with a mortgage back to the company. The issue before the court was whether the solus agreement was a clog on the equity of redemption, or whether it was oppressive and unconscionable, and therefore void. The court held that it was not a clog on the equity and was reasonable. Moreover, there was nothing in the transaction that made it unfair or unconscionable. No counsel appears to have argued the effect of the doctrine of restraint of trade, al-

though the court's finding that the agreement was neither unfair or unconscionable would have militated against the application of the doctrine. It should be noted that the court specifically adverted to the fact that the applicant in the case had come to the restriction, and was able to purchase the property only because he was prepared to agree to the tying clauses.

A separate line of Canadian authority deals with the case of solus agreements outside of mortgages. In *Great Eastern Oil and Import Co.* v. *Chafe*, a case which predated *Petrofina* and *Esso* by a decade, Walsh C.J. of the Newfoundland Supreme Court considered a solus agreement under which the plaintiffs supplied a gasoline pump, underground tank and other equipment to the defendant on credit. The defendant in turn agreed to purchase all his supplies from the plaintiff for a period of five years. Walsh C.J. doubted whether the doctrine of restraint of trade would apply to a solus agreement, although his conclusion that the restraint was in fact reasonable precluded an extensive discussion of this issue.

The only recent Canadian cases discussing the Esso Petroleum case are *Stephens* v. *Gulf Oil Canada Ltd*., *Denison* v. *Carrousel Farms Ltd.* and *Hiebert* v. *Pacific Petroleums Ltd*. In the Stephens case the Ontario Court of Appeal considered the position of a purchaser who buys a portion of a business subject to covenants restraining trade. The vendor, Palen, secured Gulf's consent to a transfer to Stephens and a waiver of Gulf's right of first refusal to purchase a business on condition that Stephens submit to certain restrictive covenants. In the event of a proposed sale of either portion of the business, Palen or Stephens was to have the right to purchase the other's portion at a set price. In 1966 Palen sold his portion of the business to Gulf at a price substantially in excess of that stipulated in the contract, and without offering the property to Stephens. The case turned on two issues. Stephens argued that his right to purchase was superior to Gulf's original right of first refusal. This argument was unsuccessful. Stephens then argued that Gulf's right was part of a scheme in restraint of trade and therefore was unenforceable. Since it was unenforceable, Palen could not rely on it to provide a defence to Stephens' action in breach of contract.

The Ontario Court of Appeal was persuaded by the majority judgment in the *Esso* case. Stephens had come to the restriction; it had not been imposed on property he already owned. Howland J.A. held *per curia*:

> Stephens did not have any interest in Palen's property at the time when he entered into the ThreeParty Agreement. The restrictions imposed upon him as a condition of being allowed to purchase part of Palen's property conformed with the covenants to which Palen's property was already subject. I agree with the learned trial judge that the *Esso* case is of great persuasive authority. As I have already pointed out, the House of Lords drew a fundamental distinction between a situation where a person accepts restraints on property that he already owns and one where he purchases land which is already subject to restrictions. Only in the former case can the contract be in restraint of trade. Whilst the opinions of the Law Lords that the restrictions imposed on a purchaser when he buys a property are not in restraint of trade were *obiter*, in my view they were correct. Stephens was not giving up any freedom which he otherwise enjoyed. He had no previous right to purchase the property or to trade on it. ...
>
> In my opinion, the provisions of the ThreeParty Agreement were not in restraint of trade. Stephens should not be allowed to purchase the property subject to a tie and then repudiate the provisions of the tie. Furthermore, the right of first refusal was an integral part of the restrictions which were imposed on Stephens. It was necessary to protect Gulf in the event that a purchaser should not be prepared to enter into an agreement in writing acceptable to Gulf in accordance with para. 6.

This reasoning was cogently criticized by M.Q. Connelly in a recent article. He notes:

> With respect, the Court of Appeal appears to have misapprehended the theory of the plaintiff's action. The gravamen of the action is not Stephens' attempt to avoid the restraints upon his own freedom to trade to which he submitted in l960. If it were, then the circumstances under which he submitted to such restraints might be of controlling importance. Rather, Stephens is suing Palen for breach of a contract by which Palen agreed not to sell his land without first offering it to Stephens, and he is suing Gulf for tortious interference with that contract. The alleged primacy of Palen's obligation to extend to Gulf the first right to purchase the land in question is a matter for Palen's and Gulf's respective defences, and Palen's obligations to Gulf have their origin not in the l960 tripartite agreement but in the l956 agreement for loan. Stephens' claim is precisely the nonenforceability of an agreement in restraint of trade, but the agreement attacked is the one in l956 and not the one in l960.

Connelly concluded that Stephens did have the *locus standi* to question the enforceability of the l956 agreement, on the ground that Palen could not raise it as a defence if it were unenforceable.

It is, however, significant that the court did not quarrel with the submission that at least some vertical restrictions may be void if they unreasonably restrain trade. The debate in Canada, as in England, turns on whether the fact that the covenantor is not restricting a freedom already enjoyed should be significant.

In *Hiebert* v. *Pacific Petroleums Ltd.*, a decision of the Manitoba Court of Queen's Bench, this distinction was accepted, although on the facts of the case it was held that the restraint was void. The plaintiff purchased the land on which a service station was constructed. To take the benefit of a tie with Pacific Petroleums, he leased the property to it. In its turn, Pacific Petroleums subleased the property back to the plaintiff. The restraints were imposed in the sublease, and the agreement structured in such a way that it is at least arguable that the transaction was better characterized as one in which a business was acquired subject to restraints, rather than one wherein restraints were imposed on an existing business. If that characterization had been adopted, the restraint of trade doctrine would not have applied to the agreement.

In *Denison* v. *Carrousel Farms Ltd*., a lessee of commercial premises undertook by his lease that he would not use the demised premises except as a "produce supermarket" dealing in "those items normally sold in a produce department of a retail supermarket chain." Both the original landlord and tenant had conveyed away their interest in the demised premises to the parties to the action. When the enforceability of this clause became an issue, the Ontario High Court held, applying Lord Reid's speech in the *Esso Petroleum* case, that the clause was an ordinary negative covenant governing the use of land to which the doctrine of restraint of trade should not apply, since the tenant came to the restriction.

It would appear that Canadian courts will probably be persuaded by the distinction between restraints imposed before and those imposed after the acquisition of a business. It is nevertheless open to courts in British Columbia to decline to follow the *Esso Petroleum* case, and in particular Lord Reid's dictum that the application of the doctrine of restraint of trade depends on whether a restraint is imposed upon an owner of property, or whether the owner of property acquired his land subject to the restriction. In the three Canadian cases which have considered the doctrine, its application was not strictly necessary to the decision. In the *Hiebert* v. case, the covenantee did not "come to" the covenant in restraint of trade. In the Dennison case, the *doctrine* of restraint of trade was held not to apply since the covenant was held not to regulate the defendant's right to trade. In *Stephens* v. *Gulf Oil Canada Ltd*., it is apparent on the facts of the case that the court erred in the manner in which it chose to apply the doctrine to the facts. In view of the criticism of the test in the *Alec Lobb Garage* case, it may well be that the courts of other provinces or the Supreme Court of Canada, may wish to reconsider the application of the distinction suggested by Lord Reid in the *Esso Petroleum* case.

3. The Combines Investigation Act, R.S.C. 1970, c. C23, as amended S.C. 19747576, c. 76

The common law and equity are not the only source of rules governing covenants in restraint of trade. An agreement which unduly restricts trade may have criminal as well as civil consequences under the *Combines Investigation Act*. In addition to providing for criminal penalties, the Act provides for the investigation of business practices which might unduly restrain trade, and provides through the Restrictive Trade Practices Commission a mechanism for ameliorating the effect of unduly restrictive business practices.

Part V of this Act imposes sanctions of a criminal nature on persons who attempt to unduly lessen competition. Of particular interest are sections 32 and 33 of this Act, which provide:

Conspiracy

32. (1) Every one who conspires, combines, agrees or arranges with another person

(a) to limit unduly the facilities for transporting, producing, manufacturing, supplying, storing or dealing in any product,
(b) to prevent, limit or lessen, unduly, the manufacture or production of a product, or to enhance unreasonably the price thereof,
(c) to prevent, or lessen, unduly, competition in the production, manufacture, purchase, barter, sale, storage, rental, transportation or supply of a product, or in the price of insurance upon persons or property, or
(d) to otherwise restrain or injure competition unduly,

is guilty of an indictable offence and is liable to imprisonment for five years or a fine of one million dollars or to both.

Idem

(1.1) For greater certainty, in establishing that a conspiracy, combination agreement or arrangement is in violation os subsection (1), it shall not be necessary to prove that the conspiracy, combination, agreement or arrangement, if carried into effect, would or would be likely to eliminate, completely or virtually, competition in the market to which it relates or that it was the object of any or all of the parties thereto to eliminate, completely or virtually, competition in that market.

Defence

(2) Subject to subsection (3), in a prosecution under subsection (1), the court shall not convict the accused if the conspiracy, combination, agreement or arrangement relates only to one or more of the following:

(a) the exchange of statistics,
(b) the defining of product standards,
(c) the exchange of credit information,
(d) the definition of terminology used in a trade, industry or profession,
(e) cooperation in research and development,
(f) the restriction of advertising or promotion, other than a discriminator restriction directed against a member of the mass media,
(g) the sizes or shapes of the containers in which an article is packaged,
(h) the adoption of the metric system of weights and measures, or
(i) measures to protect the environment.

Exception

(3) Subsection (2) does not apply if the conspiracy, combination, agreement or arrangement haslessened or is likely to lessen competition undulyin respect of one of the following:

(a) prices,
(b) quantity or quality of production,
(c) markets or customers, or
(d) channels or methods of distribution,

or if the conspiracy, combination, agreement or arrangement has restricted or is likely to restrict any person from entering into or expanding a business in a trade, industry or profession.

Defence

(4) Subject to subsection (5), in a prosecution under subsection (1) the court shall not convict the accused if the conspiracy, combination, agreement or arrangement relates only to the export of products from Canada.

Exception

(5) Subsection (4) does not apply if the conspiracy, combination, agreement or arrangement

(a) has resulted or is likely to result in a reduction or limitation of the volume of exports of a product;
(b) has restrained or injured or is likely to restrain or injure the export business of any domestic competitor who is not a party to the conspiracy, combination, agreement or arrangement;

(c) has restricted or is likely to restrict any person from entering into the business of exporting products from Canada; or
(d) has lessened or is likely to lessen competition unduly in relation to a product in the domestic market.

Defences

(6) In a prosecution under subsection (1), the court shall not convict the accused if it finds that the conspiracy, combination, agreement or arrangement relates only to a service and to standards of competence and integrity that are reasonably necessary for the protection of the public

(a) in the practice of a trade or profession relating to such service; or
(b) in the collection and dissemination of information relating to such service.

Exception

(7) Subsection (1) does not apply in respect of a conspiracy, combination, agreement or arrangement that is entered into only by companies each of which is, in respect of every one of the others, an affiliate as that relationship is defined in subsections 38(7) and (7.1).

Mergers and monopolies

33. Every person who is a party or privy to or knowingly assists in, or in the formation of, a merger or monopoly is guilty of an indictable offence and is liable to imprisonment for two years.

The relationship between the civil doctrine of restraint of trade and the criminal penalties imposed by the *Combines Investigation Act* were explored by the Ontario Court of Appeal, *per* Blair J.A. in *Tank Lining Corporation* v. *Dunlop Industrial Ltd.*:

> The traditional constitutional justification for validity of federal anticombines legislation has been that it fell under the head of criminal law: *Proprietary Articles Trade Ass'n* v. *A.G. Can.*, [1932] 1 D.L.R. 1, 55 C.C.C. 241, [1931] A.C. 310. This has meant that offences prescribed first in the *Criminal Code* and now in the *Combines Investigation Act*, must be proved beyond a reasonable doubt. This makes conviction difficult under s. 32, the section most relevant to agreements in restraint of trade ...
>
> The qualitative test resulting from the use of the word "unduly" complicates the attainment of the usual standards of proof in criminal proceedings. It has been construed by the Supreme Court to restrict the section to cases where a high degree of control of the market results from the agreement: *Atlantic Sugar Refineries Co. Ltd. et al.* v. *A.G. Can.*, [1980] 2 S.C.R. 644 at p. 659, 115 D.L.R. (3d) 21 at p. 32, 53 C.P.R. (2d) 1 at p. 11, 32 N.R. 562 at p. 575 *sub nom. R.* v. *Atlantic Sugar Refineries Co. Ltd. et al., per* Pigeon J.; *R.* v. *Aetna Ins. Co. et al.*, [1978] 1 S.C.R. 731, 75 D.L.R. (3d) 332, 30 C.P.R. (2d) 193; *Howard Smith Paper Mills et al.* v. *The Queen*, [1957] S.C.R. 403 at p. 425, 8 D.L.R. (2d) 449 at p. 472, 29 C.P.R. 6 at p. 29, *per* Cartwright J. (The amendments made to s. 32(1) by 19747576, c. 76, s. 14(1), do not affect this restrictive interpretation.) The same test has been applied to the provisions of the Act dealing with mergers: *R.* v. *British Columbia Sugar Refining Co. Ltd. et al.* (1960), 129 C.C.C. 7, 38 C.PR. 177, 32 W.W.R. 577; *R.* v. *K.C. Irving, Ltd.*, [1978] 1 S.C.R. 408, 72 D.L.R. (3d) 82, 29 C.P.R. (2d) 83.
>
> It is obvious that the covenant in restraint of trade in this case would not be likely to invite prosecution under the *Combines Investigation Act*, because it does not attain criminal proportions nor confer market dominance on the parties. It does not follow, however, that the covenant could not be regarded as unreasonable with reference to the public interest under the *Nordenfelt* doctrine. This is recognized by s. 39 [rep. & sub. ibid., s. 18(1)] of the Act which provides:
>
> 39. Except as otherwise provided in this Part, nothing in this Part shall be construed to deprive any person of any civil right of action.
>
> Where any agreement clearly contravenes the Act, it will be automatically struck down under the second branch of the Nordenfelt test as occurred in *Weidman* v. *Shragge, supra*. In other cases where an agreement falls short of offending the strict criminal standards of the Act, it will still have to face the test of the broader considerations of public interest applicable in civil actions.

This is not the place to enter into an extended discussion of the philosophy, economics of, and practice under the *Combines Investigation Act*. However, there are a number of aspects of the *Combines Investigation Act* of interest in the context of law reform, particularly as it applies to solus agreements.

Part I of the *Combines Investigation Act* (referred to in the balance of this chapter as "the Act") sets out the power of the Director of Investigation and Research to investigate a matter on the application of any six persons, not less than 18 years old, who believe either that an offence under the Act has been committed or that grounds exist for the Restrictive Trade Practices Commission to make an order under Part IV.1 of the Act. Upon such an application or, when appropriate, where he considers it proper to do so, the Director is obliged to investigate the matter drawn to his attention, and for that purpose is given broad powers to gather evidence. He may, for example, enter any premises to copy and seize relevant documents and may require evidence upon affidavit.

Part III of the Act establishes the Restrictive Trade Practices Commission. The Commission has the power to make reports, and indeed in 1962 examined the effect of solus agreements in the petroleum industry in its *Report on an Inquiry Into the Distribution and Sale of Automotive Oils, Greases, Anti Freeze, Additives, Tires, Batteries, Accessories and Related Products*.

Parts IV and IV.1 of the Act provide for a number of remedies when an agreement is found to unduly lessen competition. Of particular interest is section 31.4, which permits the Commission to order suppliers engaged in exclusive dealings to cease that activity. The Commission may also order that any further thing be done which is required to overcome the deleterious effects of the exclusionary contracts. In exercising this jurisdiction, the Commission is directed by section 31.4(2)(e) to grant a remedy if exclusive dealing or tied selling is having "any exclusionary effect on the market." The Commission is, however, prohibited in certain limited cases from making any order. Section 31.4(4) provides:

> **Limitation**
>
> (4) No action may be brought under subsection (1),
>
> (a) in the case of an action based on conduct that is contrary to any provision of Part V, after two years from
>
> (i) a day on which the conduct was engaged in, or
> (ii) the day on which any criminal proceedings relating thereto were finally disposed of,
>
> whichever is the later; and
>
> (b) in the case of an action based on the failure of any person to comply with an order of the Commission or a court, after two years from
>
> (i) a day on which the order of the Commission or court was violated, or
> (ii) the day on which any criminal proceedings relating thereto were finally disposed of,
>
> whichever is the later.

Section 31.4 has been considered in the case of *Director of Investigation and Research* v. *Bombardier Ltd.*, a decision of the Restrictive Trade Practices Commission. This case considered an application by the Director for an order prohibiting Bombardier from engaging directly in the practice of exclusive dealing, and further requiring Bombardier to resupply those of its dealers who, in breach of the exclusivity clauses of their Bombardier solus agreements, had commenced selling competing snowmobiles. In the result, although the Commission held that Bombardier was to be regarded as a "major supplier" of a product, it also found that there was no evidence that Bombardier's practice of enforcing solus agreements reduced competition or impeded the entry of new dealers into the business. Accordingly, the application of the Director was dismissed.

In a recent article, George Takach criticized the decision of the Restrictive Trade Practices Commission in the *Bombardier* case on the ground that the Commission, although correct in its decision that the *Combines Investigations Act* applied to a major supplier, and not only to the major supplier, erred in failing to recognize that the status of Bombardier as the major supplier in several of the market regions it referred to required that a sterner view be taken of its activities. Takach also pointed out that the Com-

mission's analysis of the economic consequences of the exclusive dealing contracts was unsophisticated, and ignored not only Bombardier's predominant position, but also the considerable capital investment of Bombardier dealers which would be placed at risk if they refused to abide by the solus agreement Bombardier insisted upon. Lastly, as Takach notes, the Commission in its judgment declined to set out any standards of general application to solus agreements in the snowmobile industry, or to discuss in a rigorous fashion important questions of major supplier, market share, and duration of arrangement. The decision, for that reason, appears to fall short of what one might expect of an expert tribunal seized with important questions respecting the competitive aspects of marketing practices. The Commission failed to take a sufficiently broad view of its powers to assist in shaping the marketplace to maximize the benefits of competition.

Other commentators on the effect of section 34.1 of the *Combines Investigation Act* have concentrated on its constitutionality. Although the case for the validity of the legislation seems strong, whether the Dominion's power over trade and commerce, the criminal law, or its residual power to promote peace, order and good government is relied upon, it has been noted that the power of the Restrictive Trade Practices Commission to order that remedial steps be taken may infringe provincial powers to provide for the administration of justice in the province and in particular, the constitution of the courts.

The ultimate utility of the *Combines Investigation Act* in shaping the marketplace, and in particular in limiting the potential for deleterious effects on the marketplace by virtue of the unreasonable use of solus agreements is, therefore, far from settled. It does not appear that those persons bound by solus agreements have attempted to avail themselves of the remedies vested in the Restrictive Trade Practices Commission by making application to the director for an investigation of their industry.

It must also be recognized, however, that the powers of the Restrictive Trade Practices Commission depend upon a number of jurisdictional prerequisites. In particular, the covenantee involved must be a "major supplier." Moreover, many franchise agreements are excluded by the Act by subsection 31.4(5), which deals with contracts in which the right to use a trade name is linked with an obligation to purchase a wide variety of products obtained from different sources. Lastly, the exclusive or tied selling agreement must have the potential when taken with similar agreements to "substantially lessen competition in relation to the product." Accordingly, in many cases solus agreements will not be caught by the *Combines Investigation Act*, and the reasonableness of the agreement, both for the public, and as between the parties to it, will fall to be judged by the civil standards of the common law.

4. Remedies

(a) Where the Covenant is Enforceable

In general the normal rules pertaining to breach of contract apply where a party seeks to enforce a reasonable covenant in restraint of trade. A plaintiff may seek an injunction to restrain the breach, subject always to the general rule that a court of equity will not issue an injunction which would have the effect of specifically enforcing a contract of personal service. Persons who induce the covenantor to breach the covenant may also be enjoined.

The covenantor will often in such a case seek an interlocutory injunction. In such a case, the plaintiff must both make out a reasonable case supporting the validity of the covenant and show that the balance of convenience favours the defendant being restrained. In many cases, the outcome of an application for an interlocutory injunction will determine the eventual disposition of the case by inducing the defendant to settle or the plaintiff to abandon his case. However such interlocutory injunctions are the exception and not the rule. In *Stittgen* v. *LuetkeBrinkhaus et al.*, Esson J.A. of the British Columbia Court of Appeal held:

> I have stressed that matter because it is of great importance on interlocutory applications dealing with restrictive covenants. I do not say that there are no cases in which injunctions have been granted to enforce such covenants pending

trial, although we have been referred to none, but I do think they are very rare and that the circumstances would have to be rather exceptional.

The plaintiff may also pursue an action for damages.

(b) Where the Covenant is Unenforceable

If a covenant in restraint of trade is found to be unenforceable, then under the current law an action may only be maintained on it if a court is able to sever the overly broad restraint by application of the blue pencil test. In such a case, the balance of the covenant is enforceable as if the covenant had never contained the unreasonable restraint.

However, it is not the inevitable result of the application of the general rule that the covenantee is left without a remedy. The general law provides certain safeguards to protect the interests of persons in the position of covenantees, and these should not be ignored when one is considering the effect of striking down contractual restraints of trade. It is therefore useful to examine the noncontractual remedies available to protect economic interests of this kind.

The restraints which parties to a contract may impose on each other often parallel similar restraints imposed by equity and the common law. Even though there may be no contractual restraint on the manner in which a business is carried out, a cause of action may exist where one party unduly interferes with another's economic interests. An executive who uses his inside knowledge to induce customers of a former employer to transfer their allegiance to a new enterprise may be liable for having interfered with the former employer's contractual relations. Assets which are patented or copyrighted are protected by law from unauthorized exploitation by others. Even in the absence of a patent or copyright, a person who either pretends that his goods or services are those of another, or who deliberately structures his operations so that customers might reasonably draw such a conclusion, may be liable for damages or subject to an injunction. Conduct of that kind constitutes the tort of passingoff. This tort is a relatively modern creation, whose limits have not been fully explored.

Where a business is sold together with its goodwill, and the vendor reopens next door, his action is inconsistent with the sale of the goodwill. In some jurisdictions that incompatibility may result in liability for damages for breach of contract. California courts, for example, have awarded damages where a vendor directly solicited former customers. Under California law, however, merely opening up a competing business and soliciting the public generally is not regarded as a breach of a contract for the sale of a business.

Canadian courts have also frowned upon attempts by a person who has sold an interest in a business to "reclaim" what he has sold. For example, in *Jiffy People Sales (1966) Ltd.* v. *Eliason*, a decision of the British Columbia Supreme Court, the defendant sold his shares in the plaintiff company, and then managed to secure for himself the distributorship which was the company's main asset. Hutcheon J. awarded damages for lost earnings occasioned by the defendant's conduct which he found amounted to a breach of contract.It is not material to consider whether, on the sale of a goodwill, the obligation on the part of the vendor to refrain from canvassing the customers is to be regarded as based on the principle that he is not entitled to depreciate that which he has sold, or as arising from an implied contract to abstain from any act intended to deprive the purchaser of that which has been sold to him and to restore it to the vendor. I am satisfied that the obligation exists, and ought to be enforced by a court of equity.
See also J.L.R. Holdings Ltd. v. *Wiseberg*, (1977) 16 O.R. (2d) 809, 79 D.L.R. (3d) 305 (Ont. H.C.), *aff'd.*21 O.R. (2d) 839 (Ont. C.A.); *Commercial Transport (Northern) Ltd. et al.* v. *Watkins et al.*, (1983) 22 B.L.R. 249 (Ont. H.C.) at 2523.

At the same time, British Columbia courts have been unwilling to imply a general noncompetition clause in contracts for the purchase and sale of a business. In *Read* v. *Wright*, Munroe J. was not prepared to imply a covenant on the defendant's part not to operate a shoe store in competition with the business he had sold, even though it appeared that the parties intended that no such business would be operated. But what were the terms of such covenant? Here the evidence falls far short of the degree of certainty required by law, both as to time and area, to justify the granting of an injunction in the terms requested. Is the restriction to apply during the lifetime of the defendant or for a lesser fixed period? Is it to apply only whilst the plaintiffs remain in possession of the store? Is the restriction to apply to a designated number of miles from the plantiffs' store premises, or to Abbotsford village, or to the area of the three municipalities named? Upon the evidence, I cannot say the covenant not to compete is altogether too vague and is therefore void

for uncertainty. If the court were to draft a restrictive covenant, the court would be doing for the parties what they themselves had failed to agree upon and do for themselves.

Courts of equity have repeatedly demonstrated their concern to protect confidentiality and legitimate trade secrets. In *Seager* v. *Copydex*, Lord Denning M.R. expressed the view that there is a broad principle of equity that:

> he who has received information in confidence shall not take unfair advantage of it. He must not make use of it to the prejudice of him who gave it without obtaining his consent.

In Seager, the defendant had innocently appropriated the plaintiff's device for securing carpets, which had been shown to the defendant in confidence. The plaintiff was awarded damages in lieu of an injunction, calculated on the value of the confidential information to a willing buyer.

In *Management Recruiters of Toronto Ltd.* v. *Bagg,* the plaintiff sought an interim injunction in order to enforce a simple covenant not to compete. Wells C.J.H.C.was of the view that the covenant was unreasonable and unenforceable. However, that did not end the matter. When the defendant left the plaintiff's employ, he took with him 32 job orders and 148 prospect files. Wells C.J.H.C. was prepared, despite the invalidity of the restrictive covenant, to grant an injunction to prevent the misuse of the confidential files:

> I think the fact that he took these things with him brings him partially in the area of confidential employment and would appear to remove him from the type of case which the Courts have consistently refused to enforce as against public policy. And I would not desire to grant an interim injunction on the present state of the information I have, which would in effect apply the very wide terms of the contract and terminate Bagg's employment with his present employers. I think it perfectly proper, however, to grant an interim injunction at the present time against Bagg restraining him from using in any way or doing anything to complete the 32 job orders or to utilize the 148 prospect files and an interim injunction until the trial or final disposition of this action may issue so restraining him. In my view, if this theft had not taken place, there would have been no element in the relationship of the plaintiff company with Bagg which would put him in the position of a confidential employee.

It is well established in Canada that knowledge acquired in a fiduciary or quasifiduciary position, including knowledge acquired as an employee, must not be used to the detriment of the person from whom it was obtained.

The equitable limitations on employees and executives who seek to enter into a competing business with a former employer were set out by the Supreme Court of Canada in *Canadian Aero Service Ltd.* v. *O'Malley*. The defendants were directors and officers of the plaintiff. They formed an independent company which successfully bid for and acquired a contract in which the plaintiff had been actively interested, and in respect of which the defendants in their capacity as officers of Canaero had spent considerable amounts of time. The contract was concluded only after the defendants had resigned. Nevertheless, the defendants were compelled to account for the profit received on the contract, even tho they had not acted dishonestly. Laskin J. (as he then was) summarized the defendants' obligation:

> An examination of the case law in this Court and in the Courts of other like jurisdictions on the fiduciary duties of directors and senior officers shows the pervasiveness of a strict ethic in this area of the law. In my opinion, this ethic disqualifies a director or senior officer from usurping for himself or diverting to another person or company with whom or with which he is associated a maturing business opportunity which his company is actively pursuing; he is also precluded from so acting even after his resignation where the resignation may fairly be said to have been prompted or influenced by a wish to acquire for himself the opportunity sought by the company, or where it was his position with the company rather than a fresh initiative that led him to the opportunity which he later acquired.

Accordingly, even where an agreement contains a covenant in restraint of trade which is struck down as unreasonable, it is arguable that a former employee is not free to make unrestricted use of the knowledge he acquired during his employment. The law is concerned to safeguard the employer's legitimate business interests.

However, in the recent Ontario case, *Investors Syndicate Ltd.* v. *Versatile Investments Ltd*., the High Court declined to award damages against the defendants based on a breach of this "common law duty of trust and confidence." The defendants, ex employees of the plaintiff, had, contrary to a covenant in their written agreement, solicited their former customers on behalf of their new employer. The covenant had been struck down as an unreasonable restraint of trade, being in effect unlimited in both space and time. The court held that it was impossible to imply a contractual term binding the defendants not to solicit former customers in the face of the clause struck down.

It remains to be seen whether the common law and equitable rights of the employer will be held to have been circumscribed by a clause which is held to be unreasonable and unenforceable. In *Investors Syndicate* v. *Versatile Investments Ltd.*, counsel apparently argued that there must be implied into the contract a term of similar import to that struck down. The position if a narrower common law or equitable obligation had been argued is, therefore, moot. The result in the *Investors Syndicate* case may be questioned, since the obligations of the defendants at common law and in equity were treated as a matter of implied contract rather than as independent preexisting obligations.

It would appear, therefore, that the law already recognizes and protects many of the interests purchasers of businesses, employers and franchisors who sell "know how" seek to protect through the use of covenants in restraint of trade. Moreover, it should be observed, this area of the law, and the methods by which courts deal with these kinds of problems is one in which new developments have occurred in the past few years. It is probably safe to assume that the courts will continue to develop the law safeguarding commercial interests, although the final form this law will take is far from settled.

CHAPTER III THE REQUIREMENT OF REASONABLENESS

A. Introduction

The general rule requires that a covenant, if it is to be enforceable, must be reasonable not only in respect of the needs of the parties, but also in respect of the public interest. Courts have defined a number of factors by which reasonableness may be judged, which we shall discuss in this chapter. This discussion is obviously not exhaustive, but limits of space preclude a more lengthy treatment of the subject. For example, Heydon's book devotes more than 100 pages to this issue alone.

The question of reasonableness is one which must be decided from case to case, and the relative importance of any particular factor will vary with the circumstances of the case. It must be stressed, however, that although the test of reasonableness applies no matter what the nature of a covenant in restraint of trade might be, in employee covenants the courts have always required a higher standard of proof and have displayed great reluctance to uphold restraints on a person's ability to earn a living.

The traditional view is that reasonableness is largely a question of the economic efficiency of the arrangement in question. This has led courts to develop the concept of "legitimate interests" whose protection justifies the enforcement of a covenant in restraint of trade. This approach, however, has led counsel in some cases to adduce expert economic evidence concerning the impact of the agreement in question. Faced with such evidence, English and Canadian courts have begun to restate the test of reasonableness in legal, rather than economic terms. We shall examine the traditional and the legalistic approach to reasonableness in this chapter.

B. The Traditional Approach

1. Introduction

In attempting to assess the economic impact of a covenant in restraint of trade, courts have developed the concept of an economic "interest" which would justify the restriction imposed. Hence, if when stripped of its surrounding verbiage, the covenant is a bare promise not to compete, it will not be enforced. A covenant restraining trade which is not necessary to protect some legitimate business interest is not reasonable between the parties or in the public interest.

In the context of covenants in restraint of trade, the word "interest" is used ambiguously. As Heydon notes, "Discussion of these new 'interests' show that 'interest' is a remarkably ambiguous word." He then points out that three senses of the word refer to different matters of individual and social concern:

> 1. Interest may have a general common sense meaning: we have an "interest" in something when changes in its state may affect us favourably or unfavourably.
>
> 2. Interest may be used in the more technical sense of "legitimate proprietary interest": the law permits covenants which restrain trade to be used to protect proprietary rights.
>
> 3. Interest may mean "a public interest," which is itself ambiguous.
>
> (i) It may be used to refer to an aggregate of individual interests in sense 1, or 2, or both. Thus the public interest in freedom of trade may refer to the sum of a number of private interests in sense 1 in keeping open opportunities to enter advantageous relations with others. Another example is "sanctity of property," regarded as the sum of many individual interests in preserving their property rights.
>
> (ii) "Public interest" may also refer to a matter which concerns society generally, many of these matters being reflected in the doctrine of public policy. "Freedom of trade" is also a public interest in this sense, since English public policy regards it as desirable that everyone be substantially free to enter what trading relations he wishes, not simply because this may help each individual's personal interests in sense 1, but because the whole economy and society generally is better for this. Freedom of trade is thought to avoid the dangers of political and economic domination by big firms exploiting monopoly positions; society will be more adventurous, capable of change and open to improvement.

For convenience, we will discuss the factors which courts have considered in determining "interest" in the first two senses Heydon isolates under the heading "interests of the parties," and the issues raised by questions of public interest under the heading "public interest."

2. Interests of the Parties

(a) Goodwill

The purchaser of a business as an ongoing concern may, as a reasonable man, believe that his purchase carries with it the goodwill accumulated by the vendor. In addition, the estimation of the price might well take into account the absence of similar competing businesses in the immediate area. It has long been recognized that:

> A person not a lawyer would not imagine that when the goodwill and trade of a retail shop were sold the vendor might the next day set up a shop within a few doors and draw off all the customers.

Nevertheless, it is well established that notwithstanding the average purchaser's reasonable expectations, the vendor may be restrained from competing only if he has specifically agreed not to compete.

Restraints against competition when a business is sold have long been recognized as necessary for the protection of the purchaser's proprietary interests in his business. Like all such covenants, restraints on the vendor must be reasonable both as to time, space, and type of activity prohibited. The cases dealing with reasonableness in terms of time and space are numerous. It is well established that the covenant must not be more extensive than the area in which the business is carried on. However, in determining that area the courts will be practical in measuring the impact of a business on the surrounding area and will not require proof that the business was carried on in every village in the area. Future plans for ex-

pansion will be considered, and a covenant in respect of a specialist business with a limited market may be valid for large areas. In the *Nordenfelt* case, a worldwide restraint against competing in the armaments business was held valid.

The issue of the duration of the covenant is closely related to the issue of the area in which the covenant is to be effective. In *Proctor* v. *Sargent*, Tindal C.J.stated:

> ... where we once hold a restriction to be unreasonable in point of space, the shortness of the time for which it is imposed will not make it good, yet where the question is whether the restraint is unreasonable or not in point of space, that which would be unreasonable were it to continue for any length of time may not be so when it is to last only for a day or two.

There are many cases dealing with the temporal aspects of covenants in restraint of trade. However, as Heydon notes:

> The body of authority on how long particular restraints may continue is vast but not very illuminating, for so much depends on the facts of each case.

For this reason, there is little value in a detailed examination of these cases.

(b) Trade Secrets

An employer or vendor of a business may have acquired commercially valuable information which deserves protection. That information may relate to manufacturing processes or it may be as simple as a list of customers. Canadian courts have long recognized that proprietary rights to trade secrets may be protected by the use of covenants in restraint of trade.

It is clear that the onus rests upon a person alleging a covenant to be necessary to protect trade secrets to show that in fact what is protected is a secret. In *American Building Maintenance Co.* v. *Shandley*, Lord J.A. held:

> What the appellant names as their trade secrets are listed in the agreement and are set out earlier in this judgment. The appellant is justified in seeking to protect their customer connection but its method of carrying on business cannot, having in mind the nature of this business, be a trade secret simply by naming it to be so. The courts cannot be precluded from saying whether the terms of the restrictions are reasonable.The law will not permit a covenant in gross simply to avoid competition, but, on the other hand, it will not hesitate to enforce a fair and reasonable covenant precluding a person from divulging trade secrets for instance, a secret process or mode of manufacturing of his former employer or from exploiting confidential information obtained by the employee concerning the employer's customers.

Heydon gives other examples of trade secrets:

> What is included under "trade secrets"? The standard examples are processes, formulae, information about customers (e.g. their names and details useful in compiling advertisements about them), information the first publication of which has value, workable scientific ideas and physical objects produced by the use of the employer's time, money or labour which save time, money or labour in future (e.g. advertisement printing blocks, order books, plans or drawings). ...
>
> The court tests "secrecy" by reference to the state of knowledge of those in the industry as a whole. So something may be a secret even though it is simple and even cheap provided others in the trade are ignorant.

Although courts will not permit an employer to restrain an employee from using the skills or knowledge acquired during employment, at the same time the law recognizes that employers depend upon their employees to maintain cordial relationships with their customers. The nature of these relationships may be such that an ex employee may easily be able, wittingly or unwittingly, to entice the employer's customers away before another employee can replace the exemployee in their confidence. This is counted a legitimate interest which may be protected by a restrictive covenant. However, the customers must be steady and not merely transient and their identity must in fact be confidential. If the covenant specifically

forbids the solicitation of former customers, it will not be breached where the former customers contact the exemployee on their own initiative.

(c) The Health of the Industry

This interest is one at the same time personal to the covenantee and a matter of public concern. If a trade is brought into disrepute or is open to being conducted in such a fashion that it can no longer be profitably continued, both the individual covenantors and the public will suffer. This argument was accepted in *Eastham* v. *Newcastle United Football Club*, although on the facts Wilberforce J. held the English Football Association's retention and transfer system to be in restraint of trade as it was not necessary in order to protect the weaker football clubs.

3. The Public Interest

As Heydon notes, "public interest" may amount to no more than an affirmation that a covenant unreasonable in the covenantee's interests may also involve some impairment of society's interests. A bare covenant not to work is in neither the covenantee's interest nor that of society, which expects its members to be productively engaged.

However, "public interest" may also involve more specific questions. Some particular concerns may sway judges to uphold transactions which severely limit competition. The courts are willing to balance questions of the supply and availability of goods and services against the benefits of unlimited competition. In *North Western Salt Co. Ltd.* v. *Electrolytic Alkali Co. Ltd.*, Viscount Haldane held:

> Unquestionably the combination in question was one the purpose of which was to regulate supply and keep up prices. But an illregulated supply and unremunerative prices may, in point of fact, be disadvantageous to the public. Such a state of things may, if it is not controlled, drive manufacturers out of business or lower wages, and so cause unemployment and labour disturbance. It must always be a question of circumstances whether a combination of manufacturers in a particular trade is an evil from a public point of view.

Similar concerns have been cited by courts dealing with vertical restraints. Heydon notes:

> The leading English authority is *Esso Petroleum Co. Ltd.* v. *Harper's Garage (Stourport) Ltd.* where two agreements by the respondent, a garage proprietor, to take all its motor fuel requirements for two garages from the appellant were reviewed. One agreement, lasting four years five months, was held valid; the other, lasting twentyone years, was held void. What interest was protected? The interest of Esso in having an assured system of outlets to the public, which enhanced the competitiveness of the industry by making it possible for new firms to enter and for existing firms to invest and expand, was held to justify exclusive requirement restraints up to five years, but not longer.

In considering vertical restraints in the petroleum industry, courts have preferred a structured and ordered market in which competition between firms occurs whenever a covenant in restraint of trade expires. This more sedate model is preferred to one wherein security of supply and orderliness of distribution are sacrificed in favour of allout competition in respect of every tankful of gas, although the latter approach has some adherents. It is debatable which approach is preferable.

Even a very brief look at the economic issues raised by solus agreements in the petroleum industry reveals that the power of the courts to determine the economic and legal characteristics of an industry, under the guise of determining whether or not a particular agreement in restraint of trade is reasonable in the public interest, may have a substantial effect on an industry. As Brandeis J. noted in *Chicago Board of Trade* v. *U.S.*:

> the legality of an agreement ... cannot be determined by so simple a test as whether it restrains competition. Every agreement concerning trade, every regulation of trade, restrains. To bind, to restrain, is of their very essence. The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress and even destroy competition. To determine that question the court must ordinarily consider the facts peculiar to the business to which the restraint is applied; its condition before and after the restraint

> was imposed; the nature of the restraint, and its effect, actual or probable. The history of the restraint, the evil believed to exist, the reason for adopting the particular remedy, the purpose or end sought to be attained, are all relevant facts. This is not because a good intention will save an otherwise objectionable regulation, or the reverse; but because knowledge of intent may help the court to interpret facts and to predict consequences.

In judging whether a covenant is in the public interest, courts pay particular attention to the availability of goods and services in the area covered by a covenant.A covenant that restricts a family doctor from practising medicine in Medicine Hat may not be in the public interest if it would unduly restrict the public's right to choose a physician. A court will not compel a drugstore to close if it is the source of supply for 2000 local residents.

C. The "Legalistic" Approach

In recent cases, courts have moved away from an economic analysis of reasonableness to a legalistic approach. The House of Lords in England in their decision in *Macaulay* v. *Schroeder Music Publishing Co. Ltd*. recently restated the test of reasonableness, and in doing so, disparaged attempts to inject economic evidence into cases dealing with covenants in restraint of trade. In his speech, Lord Diplock stated:

> It is, in my view, salutary to acknowledge that in refusing to enforce provisions of a contract whereby one party agrees for the benefit of the other party to exploit or to refrain from exploiting his own earning power, the public policy which the court is implementing is not some 19th century economic theory about the benefit to the general public of freedom of trade, but the protection of those whose bargaining power is weak against being forced by those whose bargaining power is stronger to enter into bargains that are unconscionable. Under the influence of Bentham and of laissezfaire the courts in the 19th century abandoned the practice of applying the public policy against unconscionable bargains to contracts generally, as they had formerly done to any contract considered to be usurious; but the policy survived in its application to penalty clauses and to relief against forfeiture and also to the special category of contracts in restraint of trade. If one looks at the reasoning of 19th century judges in cases about contracts in restraint of trade one finds lip service paid to current economic theories, but if one looks at what they said in the light of what they did, one finds that they struck down a bargain if they thought it was unconscionable as between the parties to it, and upheld it if they thought that it was not.

Similarly, in *Texaco Ltd.* v. *Mulberry Filling Station Ltd*., UngoedThomas J. held:

> It seems to me right in principle and in accordance with the habitual inclination of the court, not to interfere with business decisions made by businessmen authorised and qualified to make them.This seems to me a proper recognition of freedom of contract within the doctrine of restraint of trade. And I for my part would prefer to rest my decision, so far as it is concerned with reasonableness in the interests of the parties, on this ground.
>
> Such a decision would, of course, still leave the restraint open to attack on the ground that it is not reasonable in the interests of the public; e.g., the duration of the tie could be so attacked. The considerations which have been canvassed not only involve business and economic judgments which, if they are the relevant considerations, may be decisive of the conclusion of the court; they are also considerations which are prevalent throughout a considerable industry, and a decision of a court affected by such business and economic judgments on the generally limited evidence which happened to be adduced before it in a particular case may have widespread effects on economic and business policy throughout the industry. Such business and economic judgments are by their nature matters for policy decisions by business administration, government or parliament. This certainly does not mean that considerations of public interest within the doctrine of restraint of trade should be so decided, but it does tend to indicate that public interests within that doctrine are not concerned with such considerations. The doctrine grew in earlier years in comparatively simple economic and social conditions. They raised no such abstruse economic considerations as have been the subject of the expert evidence and divergent forecasting deployed in our case. Such considerations are of a different order altogether from such questions as whether a prohibition on an employee or vendor being engaged in some trade within three miles of a place is unreasonable, or indeed from the considerations in the *Nordenfelt* case itself.
>
> The submissions and evidence in our case invite the question: what is the doctrine's purpose and scope? It arises from the deep concern of our common law with the personal liberty of the citizen. So innate is personal liberty to us as a people and thus to our common law that our common law has identified it with public policy. The doctrine of restraint of trade deals with the relationship of two consequential liberties: to contract and to trade. Lord Macnaghten's formulation sets the bounds between these liberties. It thus contains as its general fundamental proposition 'All inter-

> ference with individual liberty of action in trading and all restraints of trade ... are contrary to public policy', subject to exception if it is reasonable both with reference to the interests of the parties and of the public ...
>
> But what is meant by reasonableness with reference to the interests of the public? It is part of the doctrine of restraint of trade which is based on and directed to securing the liberty of the subject and not the utmost economic advantage. It is part of the doctrine of the common law and not of economics. So it must, of course, refer to interests as recognisable and recognised by law. But if it refers to interests of the public at large, it might not only involve balancing a mass of conflicting economic, social and other interests which a court of law might be illadapted to achieve; but, more important, interests of the public at large would lack sufficiently specific formulation to be capable of judicial as contrasted with unregulated personal decision and application a decision varying, as Lord Eldon, L.C. put it, like the length of the chancellor's foot.

In like fashion, the Ontario Court of Appeal in *Stephens* v. *Gulf Oil Canada Ltd*. declined to consider in detail the expert economic evidence which proved decisive at trial. Following UngoedThomas J.'s decision in the *Texaco Ltd.* case, Howland J.A. *per curia* held:

> I am in agreement with the view of UngoedThomas, J., that in applying the second limb of the *Nordenfelt* test of reasonableness, one has to consider whether the restrictions were reasonable in reference to the interests of the public as expressed in one or more propositions of law, rather than in reference to the interests of the public at large. In this case the only proposition of law which has emerged in the wider aspect of the public interest is the right of men to trade freely, subject to reasonable restraints which are in keeping with the contemporary organization of trade. The restrictions in this case were reasonable so far as the interests of the public as expressed in this proposition were concerned. As Cheshire and Fifoot pointed out in *Law of Contract*, 8th ed. (1972), at p. 366:
>
> > Reason and justice would seem to prescribe that an agreement, reasonable between the parties, should not be upset for some fancied and problematical injury to the public welfare.
> >
> > Other propositions of law may emerge in the future in this wider aspect of the public interest, either as a result of a public inquiry authorized by statute, or a detailed judicial inquiry, against which the reasonableness of similar restrictions should be tested in a subsequent case.

Courts are moving away from economic tests and formulating the test of reasonableness in terms of the liberty of the subject and the protection of his interests. The concept of personal interests protected by law is one with which courts are familiar, but the definition of the interests to be protected in a contractual case involving a restraint of trade is still very much at large. To some extent, the reformulated test of reasonableness, concentrating as it does on the covenantor's personal interests, represents the abandonment by the judiciary of its of responsibility for the public interest.

D. The Burden of Proof

It has long been established that, generally, the burden of showing that a provision in restraint of trade is reasonable rests upon the covenantee seeking to enforce its terms. However, the onus of proving the covenant to be contrary to the public interest is on the party resisting enforcement.

CHAPTER IV THE NEED FOR REFORM

A. Generally

In this chapter, we shall examine a number of issues arising out of the exposition of the law governing covenants in restraint of trade set out in the preceding chapters. The purpose of this review is to determine whether, and to what extent, reform of the current law is desirable. These issues may be divided into two categories. The first category consists of rules of law governing contracts in restraint of trade which may be amenable to reform, but which in our view call for specialized knowledge and expertise which this Commission does not possess, or which call for research beyond the resources of the

Commission as presently constituted. The second category consists of questions which are more properly characterized as matters of legal policy.

B. Issues Respecting Which No Recommendation is Made

1. Should Judges Determine the Validity of Agreements in Restraint of Trade?

In the previous chapter we noted that the concept of a "reasonable" restraint of trade could involve judges in a lengthy and complex inquiry concerning the economic effects of upholding or striking down a restrictive covenant. It might be questioned whether or not a judge sitting in court is the proper arbiter of such a dispute, given that a determination that a particular agreement is in restraint of trade may have ramifications for entire industries. Should a judge sitting alone, dependent upon counsel for assistance, be required to undertake such a potentially onerous task?

The question of whether some body other than the court should have jurisdiction in restraint of trade cases is difficult, and is coloured by the constitutional problems which might arise were judicial functions to be assumed by another body. Could the Province appoint its members?

The Restrictive Trade Practices Commission created by the *Combines Investigation Act* is an example of a specialized tribunal to which major policy questions reflecting the structure of the market for goods and services in Canada may be submitted. However, as we noted earlier in this Report, the Restrictive Trade Practices Commission is not given the power to resolve disputes concerning a particular contract. It is concerned solely with the larger question of the market as a whole and the effect on that market of the practices of a supplier or of a combination of suppliers, although, of course, an order made by the Commission may very well affect specific contracts. Any provincial agency charged with determining individual cases concerning restraint of trade would of necessity have a very different mandate. Nevertheless its role would overlap that of the Federal Restrictive Trade Practices Commission. If the provincial agency declared a certain agreement to be enforceable, what would happen if the Restrictive Trade Practices Commission, in reviewing the industry as a whole, came to a different conclusion respecting that category of agreement? The creation of a provincial agency charged with determining the enforceability of a particular covenant in restraint of trade would be fraught with constitutional and procedural difficulties. Its economic impact would be unpredictable.

We note, moreover, that the mere creation of a specialized tribunal is no guarantee that it will necessarily be more sophisticated in its approach to the economic issues involved in a dispute. For example, the decision of the Restrictive Trade Practices Commission in the *Bombardier* case has been criticized on the ground that the Restrictive Trade Practices Commission made no attempt to articulate any standards of general application to the snowmobile industry as a whole.

In this Report, we take the involvement of the judiciary as a given factor. To justify a recommendation to create a different forum to hear disputes respecting restraint of trade would require research of a substantially different character than that undertaken for this Report. It should be stressed that we recognize the difficulty facing a judge called upon to adjudicate the reasonableness of a covenant *prima facie* in restraint of trade. However, the recommendations for reform made in this Report do not, in our view, impose upon judges tasks which are any more difficult than those they discharge under the current law.

2. Legislation Respecting Particular Contracts

Earlier in this Report, we noted that the *Medical Practitioners Act* specifically voids covenants not to practise medicine within the province. This was essentially an *ad hoc* response to a particular problem. Its implementation depended upon the legislature's perception of the public interest. In this study, we did not think it appropriate to examine specific areas of economic activity in order to formulate *ad hoc* changes to the law. Such changes should be dealt with in the context of an examination of the par-

ticular activity. We are not, moreover, aware of any call for reform of the law governing restraints of trade as applied to any particular industry.

C. Is There Any Need for Reform?

1. Generally

It may be argued with some force that the present law governing covenants in restraint of trade is working reasonably well, and that no reform is required. While it is true that the present law is (with the possible exception of cases involving solus agreements) well settled, we have nevertheless concluded that the compromise embodied in the current law, under which covenants in restraint of trade are wholly unenforceable if a court finds them to be unreasonable, is becoming increasingly unworkable in the modern day marketplace.

As G.H.L. Fridman pointed out in a recent article, the present law governing covenants in restraint of trade developed within the two standard paradigms of restraint of trade: the employment contract and the agreement to purchase a business. Fridman comments:

> It seems to have been accepted, since the 18th century, when the origins of the modern doctrine can be discerned, that in these two situations the interests of the public and the interests of the parties roughly coincided. There was a need to encourage the transmission of businesses, both from the point of view of the individuals and from the standpoint of commercial and economic progress. There was also a need to permit employees to gain employment, and develop skills, at the expense of an employer, without encouraging, let alone allowing, the employee to betray his employer's confidences, and raise himself up on the shoulders of the latter, thereby forcing the latter into decline and eventual bankruptcy. No great, divisive, complicated theories of competition were involved in such cases. The lines of distinction were clear and could be drawn with equal clarity by the courts. There was not much call for dispute about such fundamentals, at least not in the centuries between the opening of the first breach in the walls of the citadel of the old law of restraint and the development of the modern gateways into and out of that citadel.
>
> All might have been well, and the law might have proceeded in this complacent, settled, orderly fashion, had it not been for the emergence of some new instances of possible restraints, hitherto unknown to the common law. Such cases fall outside the ambit of the two paradigm instances of restraint of trade at common law and do not come within the scope of the equitable doctrine of mortgages. Instead, they raise entirely novel questions with respect to the problem of recognition and acceptance of a restraint of trade and require the courts to think again about first principles, and about the whole basis for the modern doctrine. The result has been the recent resurgence of the second limb of the classical doctrine of restraint of trade, and the renewal of interest in the question of recognition and acceptance of restraints in the light of the general public interest.

Fridman goes on to argue persuasively that the basis for judicial intervention in cases involving contracts in restraint of trade is the need to balance competing freedoms, rather than any adjustment of the economic consequences to the parties and the public of the bargain.

Whether or not one frames the relevant test of reasonableness in terms of the "fairness" of the contract, as the House of Lords has suggested, or as a question of economics, the two standard paradigms have been engulfed in the modern marketplace by a welter of contracts of great complexity intended to regulate economic relationships on a broad scale. The merits of any particular contract, and its reasonableness (particularly in the public interest) may be matters of exceeding complexity. For example, the Report of the Restrictive Trade Practices Commission on the Distribution and Sale of Automotive products was 528 pages long. We do not think that in many cases, the reasonableness of a contract will be as readily apparent today as it would have been 200 years ago.

The difficulty of gauging the requirements of public policy can lead to two adverse effects if the covenantee falls into error and draws his covenant in restraint of trade too broadly. First, the penalty for any overreaching is complete invalidity. It matters not that the covenantee may have made an honest error respecting the type or duration of the protection from competition he required. If the clause is too broadly drawn, the covenantee is deprived totally of any contractual protection, and is left to his remedies,

if any, at common law or in equity. The second adverse effect is a concomitant of the first. Many restrictive covenants are inserted into contracts to protect the value of covenantee's purchase. This is particularly so in the case of the purchase and sale of a business. For example, the purchaser of a long established shoe store will be willing to pay much more for the business if he has some assurance that its former owner cannot re open a competing business next door. If a restrictive covenant binding the vendor of the business is struck down, he will in effect recover the goodwill of the business, but as the law currently stands, will be under no corresponding obligation to repay that portion of the purchase price allocated to goodwill. He will thus be unjustly enriched.

The perils of attempting to predict the requirements of the public interest are exacerbated by the inherent difficulty in defining public policy in this context. In our Report on Illegal Transactions, we considered the role of public policy in the law of contracts, and noted that the invalidation of a contract by reason of public policy worked particular hardship on a contracting party who failed to predict the emergence of a new head of public policy.

Moreover, although it is clear enough that the common law has set itself against the undue restriction of trade, it is not at all clear what interests the common law favours. As a result, when faced with complex economic arguments based on expert opinions, courts have declined to enter into an economic debate or to endorse any particular economic viewpoint against which the validity of a contract may be measured. In the *Macaulay* case, the House of Lords held that in employment contracts, the issue was the fairness of the arrangement, rather than its economic impact.

For a party to a contract attempting to gauge the enforceability of a covenant in restraint of trade, the decision of the House of Lords in *Macaulay* and of the Ontario Court of Appeal in the *Stephens* case are singularly unhelpful. Howland J.A.'s statement invoking the "proposition of law" that men should have a right to trade freely is useful on only the most general level. The court did not put forward any other "propositions of law" which might be applicable in the future. Nor is it clear what kind of detailed judicial inquiry the court contemplated as a precondition to formulating other "propositions of law," which could apply to covenants in restraint of trade, since clearly the court was not inclined to enter into complicated economic arguments.

Although the law as set out by the Ontario Court of Appeal has yet to be applied universally in Canada, it forms part of a trend away from an economic test of reasonableness. In that regard, and given the complete lack of judicial direction on what "propositions of law" are involved in the legalistic test of reasonableness, the task of predicting the judicial reaction to a covenant in restraint of trade takes on many of the characteristics of a lottery.

We have concluded that the current law operates in an unsatisfactory manner. The judicial reaction to a covenant in restraint of trade is, in many cases, unpredictable. If the restraint is held to have been framed too broadly, the clause as a whole is struck down, without regard to the effect on the covenantee.

Moreover, the law does not approach cases of covenants in restraint of trade in a logical manner. As the Law Reform Commission of New South Wales noted:

> Suppose these facts. A owns a bakery business in Windsor. He sells the business, including the goodwill, to B and B pays the sale price. In the contract for sale A promises that he will not afterwards carry on a bakery business within fifteen miles of Windsor. Soon afterwards he sets up a bakery business at Richmond, four miles from Windsor. By this means A takes advantage of the goodwill which he had in connection with his former business at Windsor and does corresponding harm to the business which he has sold to B. B sues for an injunction to restrain A from carrying on business in Richmond in breach of his promise.
>
> A man not versed in this part of the law might think that the proper matters for inquiry by the court would be whether there was a breach or threatened breach of the contract and whether the harm suffered by B was harm to an interest which, consistently with public policy, B was entitled to protect by contract.

> But the law is otherwise. The court does not consider the actual breach; it considers imaginary breaches. Penrith and Blacktown are both within fifteen miles of Windsor. The court takes the imaginary cases of A starting a bakery business in the one or the other of those towns and sees whether that would harm the legitimate interests of B. If the answer is no, the next step is to see whether the contract can be appropriately confined by crossing out words. If not, A is at liberty to do his best to take back the goodwill which he has sold to B. This, let it be emphasized, is done in the name of public policy by a court of equity, that is, a court of conscience.

The law is in obvious need of reform. It is not so obvious how this is to achieved. In the next chapter of this Report we shall consider a number of options for reforming the law. However, we shall first turn to the question of solus agreements, and consider whether a case can be made for reform directed solely at that category of covenant in restraint of trade.

2. Reform of the Law Governing Solus Agreements

One of our correspondents, in commenting on Working Paper No. 41, *Covenants in Restraint of Trade*, noted that the refusal of courts in England and Canada to apply the doctrine ab initio to cases involving land when the covenantor came to the restriction was anomalous. He maintained that there was no functional difference between that situation and one wherein the owner of land imposes that restriction on himself.

Earlier in this Report, we canvassed the modern cases on this subject and their 18th and 19th century precursors. On the basis of this examination, we have concluded that solus agreements do not, as between the parties thereto, give rise to any unique problems requiring separate legislative treatment. We recognize that in the larger context of the public interest, an industrywide practice of structuring the marketplace by solus agreements may require examination. However, the recent amendments to the *Combines Investigation Act* discussed earlier in this Report provide ample scope for a detailed inquiry into the effect of solus agreements on any particular industry. Moreover, in the course of that investigation, the Restrictive Trade Practices Commission is given jurisdiction to order remedial steps taken, if that is necessary. There is, therefore, no need to tailor any provincial legislative reform to achieve that end.

We think that the distinction between coming to a restriction imposed on land and imposing a restriction on land already owned is not ripe for reexamination. The distinction was drawn by the House of Lords to reconcile the doctrine of restraint of trade with the well settled principles of land law under which it is lawful to restrict the use to which land can be put. It is much too early to determine the efficacy of the distinction, or indeed, its ultimate acceptability in Canada. It is, moreover, not immediately apparent how the two conflicting principles may be reconciled in some other manner without upsetting long standing arrangements concerning the use of land.

One particular aspect of the law governing solus agreements may be isolated. It has been argued that the effect of drawing a distinction between imposing restrictions on preowned land, as opposed to acquired land, may be to encourage attempts to avoid the doctrine by restructuring transactions by the device of the covenantee leasing the covenantor's property, and then leasing it back, subject to a tying covenant. However, in the English decision of *Alec Lobb (Garages) Ltd.* v. *Total Oil Great Britain Ltd*., the court clearly indicated that if the parties adopted a lease back provision as a sham to support a tying covenant and to attempt to insulate the solus agreement from the doctrine of restraint of trade by making it appear that the covenantee came to the restriction, then the court would be entitled to look at the documents as part of a single commercial transaction. However, the court also affirmed that lease back arrangements may in themselves be valuable security devices with a proper commercial purpose. In view of the willingness of courts to inquire into the true nature of the transaction in issue, it would not appear that the possibility that covenantees will attempt to insulate solus agreements from the doctrine of restraint of trade by the use of sham lease backs is one with which the courts are powerless to deal.

A. Introduction

In this chapter, we shall examine a number of options for reforming the law governing covenants in restraint of trade. In particular, we note that the effect of the preferred option for reform must be measured against the differing policies involved in employment contracts, as opposed to other contracts in which restraints on trade may be imposed. Courts have been much more vigorous in examining restrictive covenants in employment contracts in view of the scope they provide to an employer to abuse its superior bargaining position.

We now turn to the various options for reform.

B. The General Rule Should it be Retained?

The general rule as it presently stands represents a compromise between the public policy favouring freedom of trade and that favouring the protection of legitimate business interests. We recognize that the content of the test of reasonableness is uncertain, and that the traditional test could place onerous burdens on a covenantee seeking to justify the ambit of the restrictive covenant on which he relies. Nevertheless, we do not see that any other means of reconciling these two policies is feasible.

Two of our correspondents suggested that it was no longer necessary to balance these competing policies. However, they took radically different stands on which policy should prevail. One correspondent suggested that all covenants in restraint of trade should be enforceable according to their terms, without being subject to any test of "reasonableness."

The justification for this proposal turns on the availability of manpower and business opportunities. It can no longer be said, with the ready availability of training facilities, that a covenant in restraint of trade necessarily sterilizes an employee, or that the supply of goods and services in the modern marketplace is so restricted that the removal of one supplier or retailer is a matter of grave moment. The free regulation of the marketplace by commercial forces is therefore practical.

This view would also call for a radical revision of the current approach to restraint of trade, for which we detect no groundswell of support. Indeed, it would appear to be contrary to the spirit of recent amendments to the *Combines Investigation Act*.

Another correspondent suggested that any postemployment restraint on the ability of an employee should be regarded as absolutely void. In his view, the public interest was best served by enhancing employee mobility and encouraging industrial enterprise in the field in which an employee is trained. This correspondent suggested that postemployment restraints are frequently used as part of a process of harassment of exemployees, and that are often far too broadly framed by employers aware that an exemployee has neither the desire or the funds to defend an action.

While we are concerned about the possibility of employer overreaching, we do not think that a case has been made out that all employee covenants should be banned. No other correspondents raised with us the question of employer abuse of covenants in restraint of trade, although the Working Paper preceding this Report was given wide circulation. We did not receive any complaints which would indicate that employer abuse of covenants in restraint of trade is such a widespread and pernicious practice that depriving an employer of the power to insist on his employee entering into a postemployment restrictive covenant would be justified.

We are also of the view that there are positive attributes to the present rule. It encourages employers to invest in training employees, secure in the knowledge that the expense will not benefit a com-

petitor. Moreover, it encourages a full disclosure of confidential information, which enables the employer to be more efficient and which in turn benefits the employee by making his job easier. A tailormade restrictive covenant permits the employer to stipulate precisely the protection he needs, rather than relying on the present law, which may or may not protect his legitimate commercial interests.

Although we do not think that a case has been made for banning all employee covenants, we are nevertheless concerned with the possibility of overreaching in this context. This is a question to which we shall turn in the next chapter of this Report.

We have concluded that the public policies balanced by the general rule continue to be viable and important in the modern commercial world. That the application of a test of reasonableness may cause undue difficulty or hardship is a proposition which is hard to deny. However, in the absence of any superior method of balancing the two competing public policies, we think that the best approach to reforming the law is to address the consequences of infringing the general rule. The law will operate more equitably if courts are not bound to refuse to enforce an unreasonable covenant without regard to the difficulty the covenantee faced in drawing a covenant in restraint of trade which would not infringe the test of reasonableness.

C. Options for Reforming the Law Governing the Consequences of Invalidity

1. Assimilate the Rule Governing Covenants in Restraint of Trade to Those Governing Illegal Contracts

Covenants in restraint of trade are a unique example of a contract *prima facie* contrary to public policy which the courts are nevertheless willing to enforce within strict limits. In our *Report on Illegal Transactions*, we examined the law governing illegal contracts generally, and proposed the enactment of reforming legislation to ameliorate the effects on parties to illegal contracts of the law governing their right to bring action on the contract. Our conclusions respecting the current law governing illegal contracts, and our recommendations for reform, may be briefly summarized.

The general rule governing illegal transactions has two heads. If a contract is illegal, it is unenforceable by either party to the contract, unless the party seeking to enforce it falls within one of the exceptions or qualifications to that general rule. Moreover, even if the parties resile from the illegal contract, the court will not permit them to raise any issue arising out of it in an action based in restitution.

In our *Report on Illegal Transactions*, we recommended that the general rule continue to govern the initial position of parties to an illegal contract. However, the Report went on to recommend that courts be given a broad discretion to alter the consequences in law of the illegality of the contract. The recommendations excluded contracts in restraint of trade pending this Report. The text of the *Report on Illegal Transactions* left open the possibility that contracts unenforceable because in restraint of trade might be brought within the terms of the remedial legislation recommended.

If covenants in restraint of trade were brought within the legislative reform recommended in our *Report on Illegal Transactions*, then any transaction in any manner in Restraint of Trade, even if reasonably drawn, would be *prima facie* unenforceable. Under the terms of our recommendations, no action can be brought on the illegal transaction unless the court chooses to exercise its power to grant relief.

While bringing covenants in restraint of trade within our recommendations for reform contained in our *Report on Illegal Transactions* would have the beneficial effect of permitting a court to exercise the broad remedial jurisdiction contemplated by the recommendations, nevertheless we have concluded that it would be inappropriate to do so.

This conclusion was not unanimous. One Commissioner was of the view that the broad range of remedies which we recommended be available in cases of illegal transactions should also be available in cases of unreasonable and invalid restraints of trade. His views may be found in a reservation located after the last chapter of this Report.It was, however, the view of the majority that the recommendations for reforming the law governing illegal transactions proceeded on the basis that all such contracts are unenforceable, which is patently not the case with covenants in restraint of trade. Should the proposed *Illegal Transaction Act* apply to covenants in restraint of trade, then many covenants presently in force would be automatically invalidated, no matter how reasonable they might be.

This is not a desirable result. There are legitimate interests involved in many covenants restraining competition, and there is merit in permitting parties to define their own mutual obligations. If this is done fairly, then there is no need to automatically avoid the resulting agreement. Hence, the majority see no need to modify the conclusion set out in Recommendation 12 of our *Report on Illegal Transactions* that legislation to reform the law governing illegal transactions not apply to covenants in restraint of trade. Explored later in this chapter is the possibility of recommending that the courts be given some limited powers to intervene or readjust contractual relations if a covenant in restraint of trade is struck down.

2. Revise the Present Law to Provide Minimum Standards

The major problem with the present rule governing covenants in restraint of trade is the complete invalidity of a covenant which is judged to be unreasonable in the interests of the parties or of the public. If the covenant is successfully impugned, then the parties to the contract are thrown back on their rights at common law or in equity.

It has been argued that the harsh effect of the present rule could be ameliorated, therefore, by altering the current law so that it provides adequate protection should a covenant be struck down. It would be possible, for example, to provide that in every sale of a business there is implied a covenant not to compete for a reasonable time within a reasonable area. Alternatively, reforming legislation could prohibit the use of customer lists or confidential information.

Some steps in this direction have already been taken by Canadian courts. We noted in Chapter II of this Report that courts in Canada have been diligent to protect those whose proprietary rights or confidences have been abused. Although this has to some extent circumscribed the activities of a covenantor who is in a position to ignore a contractual restraint, at the same time it must be noted that courts have yet to impose upon him any positive obligations of a commercial nature tailored to the protection of all the covenantee's commercial interests. For example, in British Columbia a covenant in restraint of trade will not be implied in the absence of an express covenant to that effect.

Although this option is at first blush attractive, we do not think it to be a sound basis for reform. It would be a daunting task to attempt to define in general terms standards applicable to a potentially wide range of commercial transactions, or to determine precisely what minimum protection is required if a clause is struck down. Moreover, the current law proceeds on the basis that the right of a person to trade should not lightly be circumscribed. Imposing mandatory restraints on trade as part of the general law would substantially alter that position. We have not been able to detect any call for such a major shift in the approach to be taken to covenants in restraint of trade.

3. Partial Enforcement of Invalid Restraints

In the United States, some courts have asserted a discretionary power to pare down the terms of a covenant framed in overly broad and unreasonable terms, and to enforce it to the extent it is reasonable. Courts in 17 American states have adopted the rule that a covenant may be partially enforced by modifying its language, whether or not the covenant contains severable words. This process does not involve any invocation of the "blue pencil" test for severability. In fact, these American courts have expressly

abandoned the idea that the power to partially enforce an unreasonable covenant in restraint of trade is dependent on its severability as a matter of form.

In exercising this discretionary power, American courts do not write a new contract for the parties. Instead, the courts choose out of the universe of contractual obligations a set of reasonable covenants. In particular, the courts have not imposed on the covenantor obligations more onerous than those stipulated in the contract. The obligations in the contract are, in general, the most the covenantee can hope to enforce.

This process obviously parallels that which courts utilize in severing unreasonable portions of contracts under the "blue pencil" rule presently in force. A covenantee could enable even the most cautious court to enforce covenants to the extent they are reasonable simply by carefully drafting the restrictive covenant so that severance under the blue pencil test is facilitated. To that extent, the American courts have not made a radical departure from the present law by adopting a partial enforceability rule. Instead, they have merely abandoned the unduly formalistic "blue pencil" test of severability.

This is in fact a course advocated by this Commission in its *Report on Illegal Transactions*. In that Report we stated:

> When a court severs words from a contract, it effectively alters the obligations of the parties. However, to achieve that end, the court under the "blue pencil" test must have undue regard to the manner in which the obligation is expressed. Nevertheless, it is the deletion of an obligation, or its modification, which is accomplished. For that reason, we have concluded that the power to sever should be expressed in terms of obligations under a transaction, subject to the usual test of reasonableness of result required to be met by the current law. Such a formulation underlines that the substance of the contract has been altered, and not merely its form.

Our final recommendation was that courts should be given a power to enforce an otherwise illegal transaction without regard to the blue pencil test:

> In a proceeding respecting an illegal transaction, or property affected by it, a court should have the power to grant any remedy which it could have granted at common law or in equity, in respect of the transaction or property, as if the transaction were not illegal, and, in particular, the court should have the power to make an order for one or more of the following remedies:
>
> (f) an order that:
>
> (i) certain rights or obligations arising out of the illegal transaction are not binding on the parties and that the remainder of the rights and obligations constitute a binding and enforceable transaction; or
> (ii) the obligations arising out of an illegal transaction may be discharged in a lawful manner specified by the court
>
> provided that the court is satisfied that the remaining rights or obligations under the transaction, or the obligations to be performed, are reasonable.

A number of jurisdictions have formulated partial enforcement rules which could provide models for legislative reform in British Columbia. The American Restatement of Contracts, section 184 provides:

> **184. When Rest of Agreement is Enforceable**
>
> (1) If less than all of an agreement is unenforceable under the rule stated in § 178, a court may nevertheless enforce the rest of the agreement in favour of a party who did not engage in serious misconduct if the performance as to which the agreement is unenforceable is not an essential part of the agreed exchange.
>
> (2) A court may treat only part of a term as unenforceable under the rule stated in Subsection (1) if the party who seeks to enforce the term obtained it in good faith and in accordance with reasonable standards of fair dealing.

This rule specifies two limitations on the court's remedial power. The covenantor must not have engaged in "serious misconduct," and must have obtained the term in "good faith and in accordance with reasonable standards of fair dealing." These limitations parallel those which have been placed on partial enforcement by a number of American courts which have claimed such a jurisdiction. For example, in Wisconsin the exercise of the remedial jurisdiction was limited to cases in which the clause was "reasonable and not oppressive," while Iowa courts have specifically required that the covenantor not have acted "in bad faith" These limitations are intended to discourage overreaching. We shall discuss them in more detail later in this Report.

One difficulty with the formula adopted in section 184 is that it might be viewed simply as a restatement of the "blue pencil" test. We think that more explicit reform is warranted in British Columbia.

In its *Report on Covenants in Restraint of Trade*, the New South Wales Law Reform Commission recommended the enactment of legislation respecting the partial enforcement of covenants in restraint of trade. Its recommendations were implemented by the *Restraints of Trade Act*, subsections 4(1) to (3) of which provides:

> 4. (1) A restraint of trade is valid to the extent to which it is not against public policy, whether it is in severable terms or not.
>
> (2) Subsection (1) does not affect the invalidity of a restraint of trade by reason of any matter other than public policy.
>
> (3) Where, on application by a person subject to the restraint, it appears to the Supreme Court that a restraint of trade is, as regards its application to the applicant, against public policy to any extent by reason of, or partly by reason of, a manifest failure by a person who created or joined in creating the restraint to attempt to make the restraint a reasonable restraint, the Court, having regard to the circumstances in which the restraint was created, may, on such terms as the Court thinks fit, order that the restraint be, as regards its application to the applicant, altogether invalid or valid to such extent only (not exceeding the extent to which the restraint is not against public policy) as the Court thinks fit and any such order shall, notwithstanding subsection (1), have effect on and from such date (not being a date earlier than the date on which the order was made) as is specified in the order.

We have reservations concerning the New South Wales approach. It is complex, and stating both the general rule and the partial enforcement rule positively could lead to confusion. It might be misunderstood insofar as the present rule is that reasonable restraints of trade are valid. In addition, section 4(3) does not set out the court's options when faced with a covenant in restraint of trade with sufficient clarity to warrant its adoption. Lastly, the wording of section 3 seems to require as a precondition to relief that there be a "manifest failure" to draw a reasonable covenant. It would appear, therefore, at least arguable that partial enforcement would only be available in New South Wales if there has been deliberate overreaching.

A third model is that adopted in New Zealand. Section 8 of the New Zealand *Illegal Contracts Act*, 1970 provides:

> *Restraints of trade* (1) Where any provision of any contract constitutes an unreasonable restraint of trade, the court may
>
> (a) Delete the provision and give effect to the contract so amended; or
> (b) So modify the provision that at the time the contract was entered into the provision as modified would have been reasonable, and give effect to the contract as so modified; or
> (c) Where the deletion or modification of the provision would so alter the bargain between the parties that it would be unreasonable to allow the contract to stand, decline to enforce the contract.
>
> (2) The court may modify a provision under paragraph (b) of subsection (1) of this section, notwithstanding that the modification cannot be effected by the deletion of words from the provision.

The South Australian Law Reform Committee was of the view that this provision should be adopted in that State.

On the whole, we prefer the New Zealand formulation as a model for reform. It clearly and succinctly sets out the options open to the court, and in particular makes it plain that the power to modify a covenant does not depend upon the "blue pencil" test. Moreover, it is clear that the court need not rewrite the covenant. That relief is purely discretionary.

Section 8 of the New Zealand *Illegal Contracts Act, 1970* is framed in terms of a "modification" of the invalid covenant. This is a broad term which could be read as authorizing the court to extend the ambit of the covenant. For that reason, we prefer to speak of a power to limit a covenant, so that there can be no doubt that the plaintiff cannot have more relief than that for which the contract provides.

The New Zealand legislation refers only to "provisions in contracts." As one of our correspondents noted, a contract may in total be in restraint of trade. We do not think that the remedial jurisidiction of the court should be restricted merely to "provisions in contracts."

Our first recommendation differs from section 8 of the New Zealand *Illegal Contracts Act, 1970* in one significant respect. Section 8(c) of the New Zealand legislation refers to a deletion or modification which renders it unreasonable to enforce it as modified. Although we agree that the commercial unreasonableness of a covenant is a proper concern when the court exercises its discretion to decline to limit an overly broad covenant, we think that reforming legislation should expressly provide for a wider discretion which would permit a court to take any relevant factor into account.

The utility of this approach is illustrated by the facts of the case of *Austra Tanks Pty. Ltd.* v. *Running*. In that case, the covenantee had drawn a clause of great complexity, which took into account the possible invalidity of its covenant in restraint of trade by providing for numerous alternate areas, time periods, activities and products. There were some 82,152 different combinations of obligations. The court declined to enforce the covenant, holding it to be uncertain. (5) An order under subsection (3) does not affect any right (including any right to damages) accrued before the date the order takes effect.
It is not, however, entirely clear at what this section is aimed, since if the covenant was ab initio an unreasonable restraint of trade, it would be unenforceable and no right to damages could have accrued before the order. Under the New Zealand legislation, it is at least arguable that modification should have been possible because the alteration in such a case would certainly have been fairer to the covenantor. We would prefer that the discretion to refuse enforcement not be circumscribed within such a narrow compass.

The Commission recommends that:

1. *Legislation be enacted to provide that:*

   (a) *If a contract or a portion of a contract constitutes an unreasonable restraint of trade, a court may, by order:*

      (i) *delete a portion of the contract, or*
      (ii) *limit the effect of that contract so that, as modified, the contract would have been a reasonable restraint of trade at the time it was entered into, and*
      (iii) *subject to the rules of law and equity, enforce the contract as modified.*

   (b) *The court may refuse relief under paragraph (a) and decline to enforce the contract where*

      (i) *the deletion or limitation would so alter the bargain between the parties that it would be unreasonable to give effect to the contract as modified, or*
      (ii) *the conduct of the party seeking to enforce the contract, with or without modification, disentitles him to relief.*

This is our basic recommendation. However, there are a number of subsidiary issues which our research has led us to conclude should be addressed. Chief among these issues is the question of what, if any, controls should be adopted to prevent overreaching. We shall address that issue in the next chapter of Report. In the balance of this chapter, we shall examine a number of issues arising out of our adoption of the New Zealand *Illegal Contracts Act, 1970* as a model for legislative reform.

D. The Power to Limit an Unreasonable Covenant

1. Liability for Damages for Breach of the Modified Covenant

In New Zealand, courts have exercised their power to rewrite covenants and having done so, have proceeded to award damages and equitable relief in respect of a breach of the covenant as rewritten. One of our correspondents wrote:

> I find this an unpalatable result. It is one thing to say that a modified covenant should operate *de futuro*; it is quite another to penalize the covenantor in damages on the basis of a discretionary order to modify *ab initio*. I think this matter should be clarified, perhaps by barring all retrospective relief on a modified covenant, or at least allowing it in exceptional cases only. This would encourage proper drafting in the first place, which after all should be the ultimate goal. It would also encourage speedy resort to the courts, a desired result generally, but particularly important where a liquidated damages clause is connected with the restrictive covenant; the covenantee should not be encouraged to drag his heels till the end of the restraint period and then sue for damages.

It is possible to approach the question posed by our correspondent from a different angle. Covenants in restraint of trade are not inherently objectionable, provided they protect some legitimate business interest of the covenantee. If a covenant goes further than it must to protect that interest, then under Recommendation 1 a court would enforce it only to the extent it was reasonable. If liability is imposed *ab initio* on a rewritten covenant, the effect is to compel the covenantor to act reasonably in the circumstances, and to place upon him the risk that his conduct will infringe the rewritten contract. In order to minimize that risk, the covenantor will be compelled to take into account the legitimate needs of the covenantee in deciding to what extent the covenant may be safely ignored. At the same time, it must be borne in mind that if partial enforcement would work a hardship, the court has discretion under Recommendation 1 to refuse enforcement at all. A rule permitting enforcement *ab initio*, therefore, serves a dual purpose. It upholds the enforceability of the contract and, at the same time, promotes reasonable behaviour by both parties to the contract.

The utility of permitting the award of damages and equitable relief *ab initio* may be tested by comparing three fact patterns which may emerge in a single case. Assume that A sells to B his bakery shop, together with its goodwill. The shop is located in Burnaby, and draws its clients almost exclusively from that municipality. If B exacts from A a covenant in restraint of trade that prevents A from carrying on business as a baker anywhere in British Columbia for two years, the covenant is obviously too widely drawn. If that is so, then A may, under the present law, reopen next door to the business he sold. If the court were prohibited from awarding damages *ab initio*, then until B sought equitable relief and a rewriting of the covenant, A could do so with impunity. Once he has opened lawfully, a court would be loathe to order him to cease carrying on business, since the covenant is *prima facie* invalid. The covenantee would be limited to damages suffered *in futuro*, which, by the time the matter came to trial, might be of little use to B, either because A cannot pay or because the damage has been done.

Alternatively, A may open a bakery in Prince George, some 500 miles away. B's interests are so obviously unaffected that not only may A safely be advised that his risk is minimal, but it is also unlikely that the matter will even be litigated.

The most difficult case is one in which A opens a business in a neighbouring municipality whose inclusion in a rewritten covenant may or may not be reasonably predicted. In such a case, the court will have to weigh the competing interests of A and B. Factors which it would take into account in this context would include the nature of A's investment, its effect on B, the promptness with which B took action, and the reasonableness of A's conduct. Based on such considerations, the court could decline to enforce the covenant, redraw it so as to exclude A's new business, or if it considers A's actions wholly unreasonable, rewrite the covenant in such a manner that A will be forced to suffer the consequences of his unreasonable behaviour.

Although the idea of limiting courts to equitable relief *in futuro* is one which we find superficially attractive, on further consideration we think that retaining a judicial power of some kind to award damages *ab initio* maintains a more evenhanded approach between covenantor and covenantee. For that reason, we decline to adopt the suggestion made by our correspondent.

One other issue may be raised in this regard. Damages, being a remedy fashioned by common law courts, are awarded as of right. Nevertheless, it would be possible to limit damage claims by permitting the court to exercise a discretion to refuse to award damages in appropriate cases. The most common case in which such a discretion might be exercised is the third case discussed above.

The main argument in favour of permitting the courts to refuse a damage award on a covenant as modified is that the covenantor might be unfairly punished if he makes a reasonable miscalcuation concerning the manner in which the court will redraw the unreasonable covenant. Since it was the covenantee's overreaching which invalidated the covenant in the first place, any risk involved in rewriting the covenant should be borne by the covenantee. Moreover, in some cases the covenantor may not have access to sufficient information to judge what protection the covenantee reasonably requires, and so may unwittingly choose to conduct himself in a manner which exposes him to a possible award of substantial damages.

Although we acknowledge the force of these arguments, we have nevertheless concluded that reforming legislation should not provide that awards of damages on modified covenants be discretionary. The addition of an element of discretion in the awarding of damages will inevitably be governed by the same criteria which we think should govern the exercise of the initial decision to rewrite the unreasonable covenant. For that reason, the most appropriate time to consider hardship to the covenantor is at the time the decision is taken to partially enforce the covenant. We see nothing to be gained by permitting the courts to limit a covenant, and then to decline any remedy based upon it. In particular, in exercising its discretion to partially enforce, courts will be particularly attentive to the motives and reasoning of the covenantor who has chosen to ignore an unreasonable covenant. Any reasonable doubt concerning the proper ambit of the covenant in restraint of trade will certainly be resolved against the overreaching covenantee. In such a case, we do not think a court would rewrite the covenant and mulct the covenantor in damages unless he clearly acted in an unreasonable manner.

The court should either decline relief altogether, or redraw the covenant in such a manner that it does not provide the protection which the court would otherwise extend to the convenantee. We think that this solution strikes a reasonable balance between the parties, has some deterrent effect upon a covenantee, and lastly, is much simpler than any proposal involving a superadded remedial discretion in respect of damages.

We note that nothing in our recommendations affects the discretion of the court to refuse equitable relief such as an injunction or damages in lieu of an injunction. The discretion involved in such cases is well established and is exercised according to principles long established by courts of equity.

2. The Power to ReApportion Consideration

As we noted in Chapter IV, the effect of a court refusing to enforce a covenant in restraint of trade may be to unjustly enrich the covenantor. For that reason, it was suggested to us by one of our correspondents that when it refuses to enforce a covenant, or enforces it only in part, the court should have a further jurisdiction to order the return of the whole or any part of any consideration received by the covenantor in consideration of the covenant in restraint of trade.

The principal drawback to such a power would be the removal of another deterrent to overreaching. Overreaching which is deliberate and oppressive will probably result in the court's refusal to enforce the covenant at all, while overreaching arising out of a misjudgment or a failure to attempt to draw a reasonable covenant in restraint of trade may result in its modification. However, if the overreaching is negligent in the sense that insufficient attention was paid to properly defining the covenan tor's needs, then depriving the covenantor of the consideration which has passed will deter him from similar conduct in the future, even if the covenant is rewritten. Lastly, we think that depriving the covenantor of the consideration which has passed strikes a reasonable balance between covenantor and covenantee, given our conclusion that the covenantor should be liable for damages *ab initio* for breach of a covenant as modified by the court. For these reasons, we decline to endorse this proposal.

It will be readily apparent from our conclusions that damages should be available *ab initio* and that there be no reapportionment of consideration that we do not consider a wholesale revision of the present law desirable. The policies involved in a covenant in restraint of trade are fundamental to our legal system liberty of the subject and freedom of contract. The judicial compromise struck by the general rule is not one which should be lightly interfered with. Our intention is to remedy a defect in the application of the general rule, and not to revamp it entirely. The former task does not require that a party to an unreasonable covenant be released from all his obligations, even to the extent that they are reasonable or from the consequences of his actions if he has deliberately overreached.

3. Covenants in Restraint of Trade and the Conflict of Laws

(a) Generally

Our recommendations as presently framed make no allowance for the possibility that a contract containing a covenant in restraint of trade may be intended to take effect in more than one jurisdiction. For example, what law should apply to a contract binding the former sales manager for Western Canada of a large Canadian company not to take employment with a competing company in Manitoba, Saskatchewan, Alberta, British Columbia, the Yukon and Northwest Territories for a period of five years after the termination of his employment?

Such a contract might easily be litigated in British Columbia courts. In fact, the jurisdiction of the British Columbia courts to hear a dispute respecting a covenant in restraint of trade is not dependent upon its applicability to an activity in British Columbia. Under our Rules of Court, the fact of the domicile or ordinary residence of the defendant being British Columbia is sufficient to ground the court's jurisdiction. Alternatively the court's jurisdiction may be founded on the fact of a claim that a breach of the contract occurred in British Columbia, or even on the fact that the defendant has assets located in British Columbia. The parties may also by agreement provide that the British Columbia court shall have jurisdiction.

Given that a case may easily arise in British Columbia concerning the enforceability of a covenant in restraint of trade in a fact pattern containing a number of foreign elements, the question then arises concerning the law which should be applied to determine the enforceability of the contract. What are the British Columbia choice of law rules in this regard?

Conflicts of law may arise in this context in a number of different cases. In our *Report on Illegal Transactions*, we explored in detail the choice of law rules which apply to contracts which violate public policy. For a detailed discussion of these principles, see Chapter III of that Report. To summarize our conclusions on this point, contracts are in general governed by their "proper law," which is usually either the law expressly or inferentially chosen by the parties, or, in default of such a choice, the law of that jurisdiction with which the transaction had its closest and most real connection. The parties may expressly choose a law different than the objectively determined proper law, provided that the law has a real connection to the transaction and provided that the sole end of choosing that law was not the evasion of the objectively determined proper law.

In two cases, laws other than the proper law may be relevant. If the contract is to be performed in a jurisdiction other than that indicated by the proper law, the law of the jurisdiction in which the contract may be performed may also apply. Secondly, the application of any foreign law in British Columbia is subject to overriding questions of British Columbia public policy. Hence, if the foreign rule governing the contract is contrary to the essential public or moral interest of British Columbia, it will not be applied.

The proper law of a multijurisdictional contract enjoining competition in a number of provinces may be difficult to discern in the absence of an express or implied agreement. Although in general AngloCanadian law prefers reference to only one law to govern the contract, this may be a situation in which the law of the various jurisdictions involved should govern the validity of the contract in that jurisdiction, since any other rule would be impractical.

Whatever the choice of law indicated by the application of the "proper law" test, a question arises whether the freedom of the subject to trade is such a fundamental matter of public policy that an unreasonable covenant should be refused enforcement even if by its proper law it would be valid. This precise question arose in the English case of *Rousillon* v. *Rousillon*, an 1880 decision of the English Court of Chancery, in which Fry J. held:

> Before leaving this part of the case I wish to refer to two other points raised by Mr. Cookson, because they were fully argued by him. He has insisted that, even if the contract was void by the law of England as against public policy, yet, inasmuch as the contract was made in France, it must be good here, because the law of France knows no such principle as that by which unreasonable contracts in restraint of trade are held to be void in this country. It appears to me, however, plain on general principles that this Court will not enforce a contract against the public policy of this country, wherever it may be made. It seems to me almost absurd to suppose that the Courts of this country should enforce a contract which they consider to be against public policy simply because it happens to have been made somewhere else. Again, Mr. Cookson urged that, although the policy of this country promotes trade amongst its native subjects, there is no such policy in favour of trade carried on here by foreign merchants, and no such leaning of the English law in favour of their trade. It appears to me that that view cannot be maintained. And, as an elementary point may be met by a citation from an elementary book, I will only refer to a passage in Mr. Justice Blackstone's Commentaries, in which he deals with the mode in which the English law has regarded trade by foreign merchants. He says: "The law of England as a commercial country pays very particular regard to foreign merchants in innumerable instances," and then he goes on to refer to the provision of Magna Charta in favour of foreign merchants.
>
> I hold, therefore, that neither of those two arguments could succeed.

Although the modern test of overriding public policy is more stringent than that stated by Fry J., nevertheless we are of the view that the freedom of a British Columbia resident to trade is a matter which the courts will likely regard as a fundamental matter of public policy, and subject to British Columbia law, as the *lex fori*. However, if the contract is enforceable both by its proper law and by British Columbia public policy, the proper law will continue to govern the contract.

Although if correctly decided, the *Rousillon* case establishes that a contract may be unenforceable even if valid by its proper law, it is, of course, silent on the question of the court's power to rewrite the covenant to bring it within reasonable bounds. Should the power we have recommended apply to contracts with a foreign element and, if so, to what extent?

One of our correspondents wrote:

There is some doubt as to whether the power to modify extends to a contract the proper law of which would not be B.C. Indeed, there may be a constitutional objection to modifying such a contract. Nevertheless a B.C. court, while perhaps not having jurisdiction to modify such a contract, should be empowered to deny or grant injunctive or monetary relief on the same basis as if the contract had been governed by B.C. law.

A subsection (3) along the following lines might be considered:

Where the proper law of the contract or deed is other than the law of British Columbia, the court may grant or deny relief upon the same basis as if the instrument were governed by the law of British Columbia, without exercising the power of deletion or modification under subsection (1).

Although we agree in principle that whatever the law governing the contract, the British Columbia court should be permitted to modify the covenant, we think that the suggested proposal goes too far. It would, for example, permit a British Columbia court to rewrite the contract as it affects obligations to be performed in other jurisdictions. In respect of any duty or obligation concerning things to be done or abstained from in British Columbia, we consider it proper for the British Columbia court to modify the covenant, since a matter of the fundamental public policy of British Columbia is in issue. However, insofar as the action seeks to enforce obligations respecting actions to be taken, or not taken outside the province, that is a proper matter to be resolved by the law indicated by British Columbia choice of law rules.

We are concerned with the opening words of the suggested proposal. The proper law is not the only law which may govern the validity of a contract. Nor do we see any utility in limiting the court's power to delete or modify. We have also given some consideration to the status of the law governing the contract insofar as it relates to obligations which do not relate to British Columbia. In such a case, we are content that the remedies available under the balance of the contract, if any, be a matter for the law indicated by the British Columbia choice of law rule which applies.

The Commission recommends that:

2. Where a contract or portion of a contract in restraint of trade

(a) is governed by a law other than the law of British Columbia, and
(b) imposes an obligation in respect of something to be done or not to be done in British Columbia

a court should be able to grant or refuse relief in respect of that contract that it could have granted had the contract been governed solely by the law of British Columbia, to the extent that

(c) the contract is in restraint of trade, and
(d) the relief is limited to the obligation to do or not to do something in British Columbia.

4. Transition

Recommendation 1 constitutes a new factor to be considered by parties to a covenant in restraint of trade which is drawn in too broad a fashion. Its effect could be to impose liability on a covenantor for breach of a modified covenant, which the covenantor could have ignored with impunity before the legislation implementing the recommendation came into force. Moreover, it is possible that many contracts containing covenants in restraint of trade were negotiated with the current law in mind. For these reasons, we think that our recommendations should not apply to any restraint of trade created before the legislation implementing our recommendations comes into force. This is in line with section 3 of the New South Wales *Restraints of Trade Act* of 1976.

The Commission recommends that:

3. *Legislation implementing our recommendations should not apply to contracts in restraint of trade entered into before the legislation comes into force.*

CHAPTER VI OVERREACHING

A. Introduction

Throughout this Report, we have referred to the possibility of "overreaching." In this chapter we explore the question of overreaching, with particular reference to the impact of our recommendations on this problem.

In drawing a covenant in restraint of trade, a prudent draughtsman will be aware that any covenant in restraint of trade is *prima facie* unenforceable. That sanction may be avoided, however, if the restraint is no broader than required in the *bona fide* interests of the parties and the public.

A covenant which is broader in terms of time, area, or some other salient factor, is said to be overreaching. This term signifies only that the draughtsman has gone beyond the protection to which a court holds him to be entitled by reason of the legitimate commercial interests in issue in the contract. The term is neutral, although it does have a pejorative sound. The overreaching may be deliberate in the sense that the draughtsman knowingly intended to extract from the covenantor an unduly restrictive covenant. Alternatively, the overreaching may represent at most misjudgment or negligence. The draughtsman may have tried, and ultimately failed to define the nature of the restraint in a reasonable manner, or he may have failed to address himself to the reasonableness of the restraint at all, choosing instead to rely on a standard form or to misapply a precedent. Any one of these reasons may underlie the unreasonableness of a covenant in restraint of trade. Nevertheless, under the present law, no distinction is made in the result. If the covenant is unreasonable, it is unenforceable, whatever the cause.

B. Overreaching Under the Current Law

In gauging the problem posed by overreaching, it is necessary to consider the costs and benefits under the current law to a covenantor who deliberately draws covenants wider than required. The benefits are obvious. A widely drawn covenant represents an attempt to insulate the covenantor from legitimate competition and tends to bind employees, franchisors and other covenantees to the covenantee *in terrorem*. The possibility of overreaching is, to some extent, inherent in every covenant in restraint of trade, and as J.G. Grody noted in a recent article:

> Shrewd employers know that by extracting from the employee a promise not to compete they can secure ancillary benefits as well. For example, an employee's option to leave and work elsewhere can often be a potent bargaining weapon in extracting concessions from his employer during their relationship. By restricting this opportunity, a covenant is likely to give the employer considerable leverage over the employee. Further, restrictive covenants can help an employer to retain employees in whose training they have invested time or money or who have hardtoreplace talents. Additionally, employers are naturally eager to insulate themselves against competition as such, especially competition from former employees who are familiar with their business practices.

The cost of this practice under the current law is unenforceability of the covenant should it be challenged in court. Consequently, if an action ensues on the covenant, the covenantee will be unsuccessful. He will be deprived of any protection from competition, from any damages or equitable relief which might have been awarded had the covenant been reasonably drawn and, moreover, will be liable to pay the covenantor's costs. These are said to be the principal deterrents against deliberate overreaching.

To these principal sanctions might be added extralegal deterrents. If the deliberate overreacher persists in drawing all his covenants in restraint of trade in an overly broad fashion, he will encourage challenges to the covenants. If the covenantee inevitably loses these challenges, it will impair his credibility with other covenantors and will ultimately deprive the covenants of their coercive effect. Moreover, if covenantors consistently ignore covenants imposed by a covenantee known to overreach, the covenantee will lose not only the protection of the covenants, but also whatever consideration he gave for them.

It is significant that only a relatively small number of covenants are litigated. For this reason, a covenantee may choose to risk the possibility of a challenge to the covenant in the hope or knowledge that his superior resources, deeper pocket, and ability to litigate will deter potential challenges. Moreover, by reason of the blue pencil test for severability, the covenantor's ability to coerce by overly broad covenants may be enhanced by his ability through clever drafting (for which he is presumably able to pay) to significantly increase the chance of getting some favourable result out of any litigation which may ensue.

C. Overreaching and the Power to Modify Covenants

It has been argued that the power to modify unreasonable covenants in restraint of trade could significantly enhance the possibility of overreaching. J.A. Grody argues:

> On a societal level, however, partial enforcement holds the potential to inhibit an optimal balancing of employers', employees' and the public's interests. The more significant impact of a court's decision to partially enforce an overly broad covenant is most likely felt not in the courtroom but rather in law offices. To the draftsman the possibility of partial enforcement means less cause to worry about writing a covenant which is reasonable in the first place. To be sure, the employee's selfinterest should in theory stimulate him to bargain the employer down to a reasonable scope. In practice, though, real bargaining often does not occur. Furthermore, there is little likelihood that a given covenant will ever be litigated. The problem is not, as some have suggested, that the possibility of partial enforcement is likely to lead malevolent employers to oppress powerless employees by drafting draconian restraints. Rather, partial enforcement indicates, even to the wellmeaning draftsman, that there is less need to be careful.

He states the main argument in these terms:

> It is argued that a general rule holding unreasonable covenants unenforceable *in toto* imposes on employers a forceful incentive to draft narrow restraints which conform with their actual needs. Partial enforcement severely inhibits the operation of this mechanism by insuring that employers receive "reasonable" injunctive relief even if they draft too broadly. Absent the incentive, it is argued, employers' generally superior bargaining power and understandable desire to secure maximum protection lead them to draft overprotective covenants. Employers are further stimulated to do so by the relatively small possibility that a given covenant will ever be litigated. Indeed, because employees as a rule can be expected to comply with restrictive covenants, most overly broad restraints will never be tested in court. Thus, it is concluded, partial enforcement should be denied in order to protect those employees whose covenants are never subjected to litigation.

The covenantee who deliberately draws overly broad covenants is not a phenomenon unknown to the present law. As Grody notes, an employer who relies on the coercive effect of an unenforceable covenant is counting on the reluctance of the employee to test the covenant in court. If, as Grody argues, the possibility of litigation does not enter into the decision to insist on an overly broad covenant, then it would seem that the possibility of partial enforcement by modification of the contract would not be a significant additional incentive to overreach. The almost certain negative outcome of any litigation which might ensue under the present law is simply not a factor in the decision to overreach under the current law. It is hard to see how the possibility of a positive outcome under our recommendations would make the prospect of litigation a more important factor. Moreover, in British Columbia the strength of this argument is weakened somewhat by the availability of partial enforcement by way of severance under the blue pencil test, which is itself not limited by any test designed to discourage overreaching.

Grody argues that another major drawback to partial enforcement schemes is that they lead to sloppy drafting, since there is no penalty for bad drafting. While a reasonable covenantee may not wish to overreach deliberately, he may do so inadvertently, or may choose to devote less of his resources to the

task of ascertaining the reasonable protection he requires. As a consequence, a court may be deprived of a reasoned and principled statement of the covenantee's needs.

Once again, we doubt that this criticism will necessarily apply in British Columbia. Although one of our correspondents advised that New Zealand draughtsmen were quick to broaden the scope of their covenants, in the United States it has been suggested that:

> The uncertainties attending judicial reformation of a contract containing unreasonable restrictions on competition suggest the necessity of careful draftsmanship designed to render such contracts enforceable as written.

In other words, the covenantee risks having the covenant redrawn in a manner which provides him with less protection than he in fact requires. Moreover, in seeking to persuade the court to pare down the terms of an unreasonable covenant, the covenantee must establish exactly what his needs are, with no guarantee that the court will necessarily exercise its discretion in his favour. In fact, we think that the mere fact that a covenant sets no parameters which can be justified by the covenantee will in many cases be reason enough for a court to exercise its discretion against granting relief.

It is clear that both deliberate and inadvertent overreaching is possible under the current law, particularly in view of the possibility that a court may partially enforce a contract by severance in accordance with the "blue pencil" test. Insofar as British Columbia law is concerned, therefore, the relevant question is whether removing the formalism of the "blue pencil" test will significantly enhance the rewards of overreaching. Our conclusion is that it will not.

That is not to say, however, that we are completely unconcerned with the question of overreaching. Our conclusion merely recognizes that overreaching may occur whatever rule of partial enforcement a court may adopt, either because the negligent covenantee ignores the possibility of a legal challenge to the covenant, or because the deliberate overreacher is confident that in the majority of cases, litigation will not ensue. The opportunity to overreach is inevitable given that the law permits the enforcement of reasonable restraints of trade.

Given our conclusion that overreaching is a problem whatever form of partial enforcement rule might be adopted, we think it appropriate to turn to the question of the present law dealing with overreaching, and the possibility of supplementing that law by legislation.

D. Deterring Overreaching

1. Express Controls on Overreaching in the United States

Some American courts have indicated that the exercise of the power to partially enforce is dependent upon the covenantee establishing that he obtained the covenant in issue in good faith. This requirement has been framed in various ways. The language used varies from "reasonableness" to "oppressive behaviour." This limitation has been codified in section 184 of the Restatement of Contracts referred to earlier in this Report.

In adopting this test, American courts are able to draw on a sizeable body of jurisprudence concerning the obligation of parties to a contract to act in "good faith." The Restatement of the Law of Contracts codifies this rule in section 205:

> 205. Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.

The comment following this provision states:

> The phrase "good faith" is used in a variety of contexts, and its meaning varies somewhat with the context. Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with

> the justified expectations of the other party; it excludes a variety of types of conduct characterized as involving "bad faith" because they violate community standards of decency, fairness or reasonableness. [In this context see §178: When a term is unenforceable on grounds of public policy.] This focus on honesty is appropriate to cases of good faith purchase; it is less so in cases of good faith performance ...

The requirement of good faith has also been adopted in the Uniform Commercial Code where it is defined in the case of a merchant as meaning "honesty in fact and the observance of reasonable standards of fair dealing."

American courts have had many opportunities to consider the nature of tests such as "fair dealing" and "good faith," albeit in the context of contract performance, rather than contract formation. For example, it has been held that good faith is to be measured subjectively. Bad faith involves more than bad judgment, negligence or a lack of zeal, but requires a lack of honesty, fraud, deceit orpretence. In contrast, the requirement of fair dealing imposes an objective standard.

We were unable to find any case in which an American court has declined to rewrite a covenant in restraint of trade on the ground that there had been bad faith in its formation. However, it seems fair to say that if that question arises, the courts will be concerned to discover the reason for the overreaching (i.e., is it negligent or part of an oppressive plan), as well as to determine whether the covenant was negotiated or imposed, and if the latter, whether it was imposed through an abuse of bargaining power.

2. Control of Overreaching Under Canadian Law

In contrast to American courts, courts in the Commonwealth have not formulated any general obligation to act in good faith, except in cases of oppression. However, in recent years the courts, legal commentators, and law reformers have introduced into Canadian jurisprudence concepts of "good faith" and fair dealing. For example, the Ontario Law Reform Commission recently recommended adoption of a "good faith" provision in its *Report on Sale of Goods*. This recommendation was adopted in part by a committee struck by the Uniform Law Conference to consider the Ontario Report, and consequently section 14 of the *Uniform Sale of Goods Act* now imposes an obligation to deal in good faith similar to that contained in the Uniform Commercial Code. In its *Report on Covenants in Restraint of Trade*, the New South Wales Law Reform Commission adopted as a consideration for a court the "manifest failure" to attempt to make a reasonable agreement.

Recent legal literature has explored the application of principles of good faith at common law. In a recent article entitled, *"Good Faith" in Contract Performance: Principle or Placebo*, P. Girard pointed out that although the concept of "good faith" underlies many of the legal concepts with which contract lawyers are familiar, no generalized obligation to act in good faith exists in AngloCanadian law.

A significant development in this context is the restatement by English and Canadian courts of the test governing the validity of restrictive covenants in terms of "fairness" and "conscionability." In *MacAuley* v. *Schroeder Music Publishing Co. Ltd.*, Lord Diplock pointed out that the purpose of refusing to enforce covenants in restraint of trade was "the protection of those whose bargaining power is weak against being forced by those whose bargaining power is stronger to enter into bargains that are unconscionable." He concluded that the question of enforceability turned on whether the bargain was fair. Later decisions in Eng land and Canada have confirmed that the manner in which the contract is arrived at is as important as its effect in determining whether a restraint of trade is reasonable.

Courts in British Columbia have also considered the question of overreaching in the formation of contracts. Of particular interest is *Harry* v. *Kreutziger*, in which the British Columbia Court of Appeal dealt with an action to set aside the sale of a fishing boat at a gross undervalue. The court held that the defendant had taken unconscionable advantage of the plaintiff. In the course of his judgment, Lambert J.A. held:

> In my opinion, questions as to whether use of power was unconscionable, an advantage was unfair or very unfair, a consideration was grossly inadequate, or bargaining power was grievously impaired, to select words from both statements of principle, the *Morrison* case and the *Bundy* case, are really aspects of one single question. That single question is whether the transaction, seen as a whole, is sufficiently divergent from community standards of commercial morality that it should be rescinded. To my mind, the framing of the question in that way prevents the real issue from being obscured by an isolated consideration of a number of separate questions; as, for example, a consideration of whether the consideration was grossly inadequate, rather than merely inadequate, separate from the consideration of whether bargaining power was grievously impaired, or merely badly impaired. Such separate consideration of separate questions produced by the application of a synthetic rule tends to obscure rather than aid the process of decision.

McIntyre J.A., as he then was, stated:

> From these authorities this rule emerges. Where a claim is made that a bargain is unconscionable, it must be shown for success that there was inequality in the position of the parties due to the ignorance, need or distress of the weaker, which would leave him in the power of the stronger, coupled with a proof of substantial unfairness in the bargain. When this has been shown a presumption of fraud is raised and the stronger must show, in order to preserve his bargain, that it was fair and reasonable.

Harry v. *Kreutziger* was applied in a commercial dispute between franchisor and franchisee in the Nova Scotia case of *A & K LickAChick Franchises Ltd.* v. *Cordair Enterprises Ltd*. In that case, the plaintiff franchisor sought to enforce an amended franchise agreement it had obtained through considerable pressure brought to bear on the franchisees. Richard J. held:

> Lord Denning M.R. in the *Bundy* case refers to "inequality of bargaining power" whereas Lambert J.A. in the *Harry* case uses the phrase "sufficiently divergent from community standards of commercial morality." It seems to me that these two concepts are slightly different approaches to the same principle. A finding of inequality of bargaining power cannot be made in isolation but must be relative to those standards which constitute the norm. Therefore, a transaction can be said to be unconscionable if it is sufficiently divergent from community standards or manifest a substantial inequality of bargaining power between the parties.
>
> In the present case the defendants felt that they were bound to enter into the franchise agreement because of the commitment made in the preliminary agreement. They were apprehensive as to their future in the fast food business and this apprehension was fueled by Brushett's threats to "open up across the street". They were subject to high pressure tactics and were effectively prevented from seeking independent advice. As I have already stated, they also perceived themselves to be in a substantially inferior bargaining position to Brushett. For these reasons I have no hesitation in finding that the meeting of July 18th which concluded with the execution of the franchise agreement was in total an unconscionable transaction and cannot be permitted to stand.

It seems clear, therefore, that the courts in Canada will be concerned with overreaching in commercial, as well as in consumer contexts.

The recent restatement of the law in Canada on the questions of good faith and conscionability in *Harry* v. *Kreutziger*, and similar cases, has opened the door in British Columbia to judicial examination of the cause of apparent overreaching. Where the cause is oppressive, unfair, or unconscionable behaviour, the overreacher may be deprived of the fruits of his unconscionable conduct. This power is similar in practice to that exercised by British Columbia courts exercising their jurisdiction in equity, under which equitable relief (such as injunctions or specific performance) has always been refused to plaintiffs guilty of unconscionable or inequitable conduct.

In view of the trend exemplified by cases such as *MacAuley* v. *Schroeder*, in which courts dealing with covenants in restraint of trade have expressly adverted to questions of fairness, and in view of the present law governing abuse of bargaining power and oppressive conduct generally, we do not think it to be necessary or desirable to delineate in reforming legislation the grounds upon which courts should be permitted to refuse to partially enforce covenants in restraint of trade. The question of overreaching is one to which Canadian courts are particularly sensitive, and in exercising their discretion to partially enforce a contract, they may have regard to cases such as *MacAulay* v. *Schroeder* and *Harry* v. *Kreutziger*. In view of the express adoption of tests of fairness and conscionability to determine the reasonableness of

covenants in restraint of trade, we have further concluded that no guidelines to the exercise of the discretion to refuse partial enforcement contained in Recommendation No. 1 are warranted.

3. Control of Overreaching by Limiting Remedies

In Chapter V we suggested that it was possible to deter overreaching by depriving a covenantee of any remedy in respect of the activity enjoined by the covenant in issue which preceded its rewriting by the court. While this suggestion would have some deterrent effect, on balance, and for the reasons outlined in Chapter V, we do not think such a limitation to be desirable.

4. Overreaching in Employment Contracts

It is often argued that the possibility of encouraging overreaching by covenantees is a matter of serious concern if the covenant in issue is one imposed on an employee. Employees are especially vulnerable to overreaching. There is often a great disparity in bargaining power, which enables the employer to impose his will in extracting an unreasonably wide restrictive covenant. Moreover, these covenants are much less likely to be litigated than those given in other economic relationships and the *in terrorum* value of the covenant is correspondingly greater to the employer. Finally, the environment in which the terms of a covenant are arrived at are not conducive to "hard bargaining" by the prospective employee. The nature of the arrangement is such that the parties contemplate a continuing relationship. Few employees will wish to "start off on the wrong foot" with a future employer, or be labelled as "difficult" a result that might well flow from realistic bargaining when an employee is engaged. In responses to this argument, we attempted to secure information on the experience of those American jurisdictions which have enacted legislation significantly narrowing the enforceability of employee covenants. The results of our survey were inconclusive.

One American approach is to render totally ineffective covenants given by certain classes of employees even if such covenants would be regarded as "reasonable" and thus enforceable at common law. Earlier in this Report, we gave our reasons for declining to recommend that legislation be enacted to modify the position at law of any particular type or class of employees. We do not perceive any need for this type of reform.

An alterative approach is to restrict the power of the courts (under Recommendation 1) to modify unreasonable covenants imposed on employees. Some American States which have adopted the partial enforcement rule by judicial reform have declined to apply it to employment contracts. In Georgia, for example, the Supreme Court has rejected a power to sever any portion of a post employment restrictive covenant. In *Howard Schultz & Assoc*. v. *Broiec*, it was held:

> According to the contract before us the employee agreed that for a period of two years he would not engage, directly or indirectly, as principal, agent, employer, employee, or in any capacity whatsoever, in any business activity, auditing practice, or any other related activity, in competition with the employer in Alabama, Georgia, Florida, North Carolina, South Carolina and Tennessee, or in competition with employer's principal wherever it may operate. The employer requests us to restrict the territory, to strike the offensive words "in any capacity" and to add words of our choosing to specify the activity forbidden to the employee. It is these very requests which are the reason for rejecting severability of employee covenants not to compete. Employers covenant for more than is necessary, hope their employees will thereby be deterred from competing, and rely on the courts to rewrite the agreements so as to make them enforceable if their employees do compete. When courts adopt severability of covenants not to compete, employee competition will be deterred even more than it is at present by these overly broad covenants against competition. We choose to reaffirm *Rita Personnel Services* v. *Kot*.

Similar reasons have persuaded some American commentators that postemployment restrictive covenants deserve special treatment. In one seminal article, it was argued:

> Courts and writers have engaged in hot debate over whether severance should ever be applied to an employee restraint. The argument against doing so is persuasive. For every covenant that finds its way to court, there are thousands which exercise an *in terrorem* effect on employees who respect their contractual obligations and on competitors

> who fear legal complications if they employ a covenantor, or who are anxious to maintain gentlemanly relations with their competitors. Thus, the mobility of untold numbers of employees is restricted by the intimidation of restrictions whose severity no court would sanction. If severance is generally applied, employers can fashion truly ominous covenants with confidence that they will be pared down and enforced when the facts of a particular case are not unreasonable. This smacks of having one's employee's cake, and eating it too.

In Working Paper No. 41, these arguments led us to the tentative conclusion that there should be no partial enforcement of any postemployment restraint. A covenant in restraint of trade in an employment contract would be wholly enforceable, or wholly unenforceable. However, on further reflection, we have come to the conclusion that the concern that an employer will be tempted to deliberately overreach when Recommendation 1 is implemented is overstated. Moreover, when such overreaching does occur, can it be said that a British Columbia court would not be able to take the employer's unconscionable conduct into account?

The discretion given to courts by Recommendation 1 is more than broad enough to permit a court to inquire into the circumstances surrounding the formation of a contract in restraint of trade, and to decline to enforce it when it was obtained by culpable overreaching, or if it is part of a concerted plan to take unfair advantage of employees. In exercising that discretion, the courts may have reference to the developing law of conscionability and fairness, both as it applies to the general law, or as it applies in particular to cases involving restraint of trade. As we noted earlier in this Report, recent cases discussing the reasonableness of restraints have focussed on the essential fairness of the bargain. The willingness of courts to conduct such an inquiry in cases involving employee covenants cannot be doubted. In *Elsley* v. *J.G. Collins Insurance Agencies Ltd.*, the Supreme Court of Canada, *per* Dickson J. expressly adverted to the distinction to be drawn between covenants in restraint of trade contained in employment contracts, and those contained in other types of contracts. Employment contracts are to be regarded *prima facie* as being between parties with an inequality of bargaining power. In such cases the covenant must stand up to "the more rigorous tests applied in an employee/employer context." In the light of these authorities, we are persuaded that the mere existence of a partial enforcement scheme will not prevent the court from carefully assessing the circumstances surrounding the formation of the employment contract. On the other hand, in cases where a genuine miscalculation has led to an employer's failure to meet the "rigorous" tests used in determining the validity of an employee contract, to permit partial enforcement seems fair. We think that British Columbia courts are sophisticated enough to identify those cases in which an employer has abused his position.

There is some force to the argument that since most covenants in restraint of trade do not lead to litigation, the impact of Recommendation 1 on practice outside the courts must be determined. We have already given our reasons for doubting whether the deliberate or negligent overreacher will be concerned with the potential outcome of litigation.

Under the present law, the main deterrent to overreaching is the invalidity of the covenant. Under our recommendations that deterrent still exists. The court may refuse to partially enforce. The overreacher cannot know that he will succeed. Accordingly, as one American commentator has noted, prudence dictates that a covenantee make some effort to define a reasonable covenant.

Our conclusion, therefore, is that there is no need to define any specific rules to apply to covenants in restraint of trade found in employment contracts. The courts have already done so. To the extent that any rule of law can deter a deliberate or negligent overreacher, we think that the judicial discretion exercisable under Recommendation 1 does so. We do, however, see some virtue in underlining that Recommendation 1 is not intended to affect the "rigorous" tests imposed in employee covenants in restraint of trade. For that reason, we have concluded that reforming legislation should specifically indicate that the circumstances surrounding the formation of a contract of employment are of particular importance in judging the validity of a covenant in restraint of trade contained in it.

The Commission recomends that:

4. *No special provisions should be enacted to discourage overreaching by covenantees.*

5. *Reforming legislation should specify that in exercising its discretion to partially enforce a covenant in restraint of trade contained in a contract of employment, the court should have special regard to the circumstances of the formation of the contract.*

CHAPTER VII CONCLUSIONS

A. General

This Report examines the law relating to covenants in restraint of trade. The law is in a state of flux. New Zealand and many American jurisdictions have opted for a partial enforcement regime intended to strike a fairer balance between covenantor and covenantee. English and Canadian courts, in contrast, have been more concerned with changing the focus of the law governing covenants in restraint of trade to one in which the fairness and conscionability of the covenant is an important factor in its enforceability. Both developments have been accompanied with some controversy.

In this Report, we have attempted to synthesize from these two contrasting streams of authority reforming legislation which will enhance the court's ability to uphold reasonable contracts, and which will permit the court to avoid punishing an "innocent" overreacher. We have concluded that the willingness of Canadian courts to inquire into the fairness and conscionability of commercial contracts permits the reform of the present law to enable the court to be more flexible in its approach to unreasonable restraints of trade.

B. List of Recommendations

1. *Legislation be enacted to provide that:*

   (a) *If a contract or a portion of a contract constitutes an unreasonable restraint of trade, a court may, by order:*

      (i) *delete a portion of the contract, or*
      (ii) *limit the effect of that contract so that, as modified, the contract would have been a reasonable restraint of trade at the time it was entered into, and*
      (iii) *subject to the rules of law and equity, enforce the contract as modified.*

   (b) *The court may refuse relief under paragraph (a) and decline to enforce the contract where*

      (i) *the deletion or limitation would so alter the bargain between the parties that it would be unreasonable to give effect to the contract as modified, or*
      (ii) *the conduct of the party seeking to enforce the contract, with or without modification, disentitles him to relief.*

2. *Where a contract or a portion of a contract in restraint of trade*

   (a) *is governed by a law other than the law of British Columbia, and*
   (b) *imposes an obligation in respect of something to be done or not to be done in British Columbia*

a court should be able to grant or refuse relief in respect of that contract that it could have granted had the contract been governed solely by the law of British Columbia, to the extent that

(c) the contract is in restraint of trade, and

(d) the relief is limited to the obligation to do or not to do something in British Columbia.

3. *Legislation implementing our recommendations should not apply to contracts in restraint of trade entered into before the legislation comes into force.*

4. *No special provisions should be enacted to discourage overreaching by covenantees.*

5. *Reforming legislation should specify that in exercising its discretion to partially enforce a covenant in restraint of trade contained in a contract of employment, the court should have special regard to the circumstances of the formation of the contract.*

C. Acknowledgments

We wish to thank those who took the time to consider and respond to the Working Paper which preceded this Report. In addition, we would like to acknowledge the contribution of the Honourable Mr. Justice Aikins, former Chairman of the Commission, and of Mr. Kenneth C. Mackenzie, formerly a Commissioner, who participated in settling the terms of Working Paper No. 41, Covenants in Restraint of Trade, and who participated in discussions leading to the settling of this Report. We would also like to express our appreciation to Mr. Anthony J. Spence, our former Counsel, who assisted us in preparing the final draft of Working Paper No. 41.

Finally, we wish to express our thanks to Fred Hansford, one of the Commission's staff lawyers. He carried the burden of reasearch on this project, prepared the inital drafts of the Working Paper and, subject to direction from the Commission, prepared this Report.

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April 26, 1984

RESERVATION BY ANTHONY F. SHEPPARD

Despite my reservation I have actively participated in the formulation of the recommendations contained in the *Report on Covenants in Restraint of Trade*, and as far as they go, I endorse them. My concern is that the Commission should have integrated those recommendations with the recommendations contained in the *Report on Illegal Transactions* (LRC 69). By statute one of the Commission's purposes is the elimination of existing anomalies in the law; obviously, it should not create new ones. In my opin-

ion, unless some minor amendments are made to the recommendations in the Reports, their implementation will create such an anomaly.

The Report on Illegal Transactions

In the *Report on Illegal Transactions*, an illegal transaction is defined as including a transaction that contravenes the policy of the common law. By that definition, a covenant which is an unreasonable restraint of trade, because it contravenes the common law policy of encouraging free competition in the marketplace, qualifies as an illegal transaction. At common law, the drastic consequences of illegality generally are:

(1) the transaction is unenforceable;
(2) there is no restitution of money or property which the parties have transferred pursuant to the transaction.

However, because the courts consider an illegal restraint of trade as a relatively less serious violation of public policy, it is not subject to the first consequence of illegality provided it is reasonable. If it is unreasonable, through severance, limited enforcement can be effected. For this reason, covenants in restraint of trade are sometimes described as "void" rather than "illegal". But since there is in general no restitution of benefits conferred under an unreasonable restraint of trade, it does bear a principal characteristic of illegality. If such covenants were treated as merely "void", restitution would probably be more readily available.

In the *Report on Illegal Transactions*, the common law's refusal to grant remedies where a transaction was illegal was called "the general rule" and at page 72, the Commission acknowledged that under its recommendations, it applied to an illegal restraint of trade:

> Covenants in restraint of trade would *prima facie* fall within the definition of an illegal transaction we have recommended, and unless specifically excluded would therefore be subject to the court's remedial powers under such legislation.
>
> Covenants in restraint of trade present problems of a very different nature than other forms of illegal transactions. The general rule does not apply to such provisions in the same manner as it does to other illegal transactions. For that reason we have elected to consider the problems posed by covenants in restraint of trade in a separate Report, in which we shall deal with the relationship between our recommendations in that Report, and this Report.

Because covenants in restraint of trade required more detailed consideration, they were provisionally excluded from the *Report on Illegal Transactions*. The division was made primarily to facilitate the Commission's analysis and was convenient because covenants in restraint of trade were slightly different from other types of illegal transactions. In the *Report on Covenants in Restraint of Trade*, the majority has concluded that illegal restraints of trade should be treated differently than other illegal transactions. The only remedy to either party is partial enforcement.

In contrast, the *Report on Illegal Transactions* recommended that legislation should be enacted conferring on the courts more liberal powers than are presently available at common law to grant remedies such as restitution and severance. In the Report the Commission criticized the common law approach to illegality as misconceived. The common law's overriding objective in refusing enforcement, restitution, and severance was the deterrence of illegality. According to the common law, if any of these remedies were generally applicable to illegal transactions, people would be encouraged to take a chance on such a transaction, expecting that the other party would probably not challenge the transaction on the ground of illegality, but that even if the party did so, there would be little to lose, since the court might enforce it anyway (enforcement) or, if the court refused to do so, at least it would permit the recovery of money or property (restitution) or delete a partial illegality and enforce a cutdown lawful version of the original transaction (severance). However, the Report also criticized the arbitrary exceptions to the general rule which the common law developed to permit some enforcement or restitution: for example, if the

parties were not *in pari delicto*, the more innocent party could enforce the illegal transaction or obtain restitution; or, if a party "repented" so that he had a *"locus poenitentiae"*, he could obtain an order for restitution. The Commission, in the Report, rejected the common law approach as too rigid and arbitrary, and recommended that the common law rules be abolished. The Commission also proposed that legislation should be enacted permitting the courts to determine whether restitution or severance was appropriate by assessing the facts of each case according to basic policies rather than rigid rules of law. In my opinion, that broad remedial approach to restructuring contractual ralations should also apply to covenants in restraint of trade.

The Report on Covenants in Restraint of Trade

In the *Report on Covenants in Restraint of Trade*, the Commission examines the common law power of severance as the courts applied it to covenants in restraint of trade and recommends that legislation be enacted to liberalize the power so that the courts can salvage more covenants in appropriate cases.

But the proposal has express limitations: it is discretionary and the court can refuse severance if either it would create for the parties an unreasonable contract or the party seeking severance has been guilty of misconduct. This would mean, for example, that the court would not grant severance where the illegal restraint in its original form was an essential term of the contract so that reducing its scope would make an unreasonable contract between the parties. Similarly, a court could refuse severance to penalize the covenantee's unreasonable delay or deliberate overreaching.

An implicit limitation on the proposed power of severance is that it will be ineffective where the covenantee had no "legitimate" interest, as defined by the courts, to protect by the covenant. Severance is useful where a covenant in restraint of trade offends the policy of the common law because it is unreasonable in its duration, geographical scope or range of prohibited activities. As long as the covenantee has a legitimate interest to protect the court can cut back the covenant. But where the covenantee had no legitimate interest to protect, any restraint is unreasonable and no amount of severance can reduce its scope to make it reasonable. For example, it is wellestablished that an employer has no legitimate interest simply in preventing an employee from competition after the termination of employment. Such a covenant in restraint of trade is valid only to the extent that the employer intended to protect some legitimate interest such as trade secrets, customer lists, or the prevention of the unfair stealing of his customers by the former employee. Because of these limitations on the proposed remedy of severance and the withholding of other remedies or common law, it is necessary to consider whether the proposals in the *Report on Illegal Transactions* should apply to illegal restraints of trade.

Should Restitution or Other Remedies be Available?

Where a covenant constitutes an unreasonable restraint of trade and severance cannot make it lawful, should the parties be entitled to restitution or the other remedies that are possible under the proposals in the *Report on Illegal Transactions*? To take a specific example, if an employer paid an employee a $10,000 bonus for signing a noncompetition covenant and then the employee terminates the employment and enters into direct competition with the former employer because the covenant is illegal and can be ignored, whether the employer should be entitled to recover his $10,000 or any part thereof should be determined according to the proposals in the *Report on Illegal Transactions*. The majority of the Commissioners feel that the employer should not recover the $10,000 on the policy ground of deterring overreaching regardless of the other merits of the case and that the common law rules should continue to apply to covenants in restraint of trade. But they do not want the common law rules to apply to other types of illegal transactions. Since the common law itself considered re straints of trade to be a relatively less iniquitous violation of public policy, I find the majority's reasoning inconsistent, for the result would be that parties to an illegal restraint of trade would be more heavily penalized than parties to other types of illegal transactions. If the employer had deliberately overreached, the court can penalize that misdconduct under the proposals by denying severance. In my view, whether further penalties should be imposed, such as the denial of restitution, is a matter which should be left to the court to determine by assessing the

facts in light of the basic policy considerations set out in the proposals for illegal transactions. A simple amendment to the proposed *Illegal Transactions Act* should provide that an illegal restraint of trade is subject to the proposals regarding severance contained in the *Report on Covenants in Restraint of Trade* and if such proposals are ineffective to validate the restraint, then the other possible remedies such as recission, compensation, restitution or severance *in toto*, that are set out in the *Report on Illegal Transactions* should apply to the covenant.