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Backgrounder

LRC 74—Report on Covenants in Restraint of Trade

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Covenants in restraint of trade arise in variety of different contexts. A business that has lost an executive may have a legitimate interest in preventing him or her from divulging its business secrets to competitors or from taking advantage of his or her former position by stealing customers. Frequently a contract under which an employee is hired prohibits the employee, on ceasing employment with the employer, from setting up business on his or her own account, or entering into employment with a rival firm. 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 or enlarge their market share by agreements that bind a retailer or the purchaser of a franchise to deal exclusively with the manufacturer or producer.

The report begins with a discussion of the current law in relation to covenants in restraint of trade. By way of introduction, it traces the changing attitude of the common law courts towards such covenants, from medieval times through to the nineteenth century and the seminal case of *Nordenfelt v. Maxim Nordefelt Guns and Ammunition Co.,* which concluded that the only true question was whether in the circumstances of the case the restraint was reasonable. The approach in the *Nordenfelt* case has generally been persuasive in Canada and is well entrenched. It is noted, however, that the courts have on occasion sought to evade the general rule principally by application of the "blue pencil" test where the courts sever portions of offending covenants and enforce a covenant to the extent that it is reasonable. A similar but more flexible approach in America is also outlined.

As part of the general discussion of the current law, the report looks at the type of contracts that are caught by the general rule. Attention is given in particular to solus agreements, otherwise known as vertical restraints, which are increasingly being used. A vertical restraint is one agreed to by parties occupying different positions in the industry. For example, a manufacturer of a product wishing to ensure its orderly and continued retail distribution may do so by entering into an agreement with a retailer obliging it to purchase a certain quantity of the product in a given period exclusively from the manufacturer. Contracts between garage owners and major oil companies, brewers and bar owners, and franchisors and franchisees, often take the form of solus agreements.

The report then moves on to discuss the requirement of reasonableness in restraint of trade covenants. 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. The traditional view is that reasonableness is primarily a question of the economic efficiency of the arrangement in question and 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 has led counsel in some cases to adduce expert 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. Both the traditional and the legalistic approach are examined in the report.

The report then turns to look at whether, and to what extent, reform of the current law is desirable. It divides the issues 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 the commission believes call for specializes knowledge, expertise, and research beyond the resources of the commission. In particular, the report raises the fundamental question of whether judges are best placed to determine the validity of agreements in restraint of trade or whether some other body should have jurisdiction. The second category consists of questions that are more properly characterized as matters of legal policy. The conclusion drawn is that the current law operates in an unsatisfactory manner with the judicial reaction to a covenant in restraint of trade, in many cases, unpredictable.

The commission examines a number of options for reform. It begins by considering whether the general rule regarding reasonableness should be retained. The conclusion reached is that the general rule should be retained and that reform should instead be approached by addressing the consequences of infringing the rule. A number of possibilities are discussed including assimilating the rule to that governing illegal contracts, providing minimum standards by, for example, implying a covenant in every sale of a business not to compete for a reasonable period within a reasonable area, and partial enforcement of invalid restraints to the extent that they are reasonable. The report comes down in favour of the last option adopting as a model for legislative reform the New Zealand *Illegal Contracts Act, 1970.*

A chapter of the report is also devoted to the specific issue of overreaching. Essentially overreaching occurs when a covenant is drafted so that it is broader in terms of time, area or some other salient factor than is required in the interests of the parties and the public. The report examines overreaching under the current law and possible options to deter it. The conclusion reached is that there is no need for special provisions to discourage overreaching but reforming legislation should emphasize that a court, in exercising its discretion to partially enforce a covenant in restraint of trade, should have special regard to the circumstances surrounding the formation of the contract.

Further Developments

The report's recommendations have not been implemented by legislation.