A Director's Guide to
EXECUTIVE COMPENSATION

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Non-Competition Agreements

The Real Concerns they Cause

This newsletter comments on the practical concerns caused by the overuse of overly broad non-competition and non-solicitation clauses in employment agreements. Clauses that restrict an executive's post-employment activities, such as non-competition and non-solicitation clauses are referred to as restrictive covenants. Generally, non-competition clauses are those that restrict the executive's ability to work for a competitor of his or her former employer for a specified period of time in a specified geographic region. Generally, non-solicitation clauses are those that restrict the executive from soliciting the clients or employees of his or her former employer for a specified period of time. Typically, non-solicitation clauses do not restrict the former executive from working within the industry or for a competitor, but only restrict the executive from making use of his or her relationships with his or her former clients and employees, to the detriment of his or her former employer.

Restrictive covenants in the employment context are viewed as a restraint on trade and against public policy. Consequently, courts have been loath to enforce restrictive covenants in the employment context and presume them to be void and unenforceable against the former executive. To rebut the presumption, an organization seeking to enforce them must prove they have a proprietary interest warranting protection and that the covenant is reasonable in protecting that interest. Organizations must prove the covenant is reasonable in terms of its:

- geographic scope
- duration, and
- subject-matter of the restraint

Courts vigorously apply this test to restrictive covenants in the employment context to ensure the covenants impair the executive's mobility the least

These quarterly newsletters provide practical advice and current legal comments on executive compensation and compensation governance and disclosure. These newsletters will be of interest to directors, executives, lawyers and human resources professionals.

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From the Editor

The inclusion of non-competition and non-solicitation clauses in employment agreements has become common practice, especially in senior management and executive contracts. Often the restrictions on the executive are so broad, they effectively prohibit the executive from working in his or her industry and earning a living for the period of time specified in the clause. The restrictions can have a devastating impact on an executive's career and livelihood.

Courts have taken into consideration whether an executive was bound by an overly broad non-competition clause in awarding longer periods of notice of termination to a wrongfully dismissed executive. So far, this has not deterred organizations from including overly broad non-competition and non-solicitation clauses in employment agreements. Considering the courts increasing willingness to award punitive damages and the devastating impact these clauses can have on executives, will courts next consider awarding wrongfully dismissed executives facing unfair restrictions on their careers and livelihoods with punitive damages?

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— *Nadine Côté LL.B.*

possible while protecting the organization's interests. If a non-solicitation clause will suffice to protect the former employer's interests, it must be used instead of a more onerous non-competition agreement; otherwise, it may not be enforceable.

This is distinguishable from the enforcement of restrictive covenants in the commercial context, such as the sale of a business. Courts are more inclined to enforce restrictive covenants in the commercial context, even if the clause is broad. In the context of a sale of a business in which an executive has profited significantly, it is often necessary to enforce the restrictive covenant to protect the business that was acquired from the executive.

Further information on the enforcement concerns associated with restrictive covenants and other aspects of restrictive covenants in Canada and the United States were outlined in our March 2010 Newsletter, Volume 5, No. 1 titled "Non-Competition Agreements: Avoid the Enforcement Pitfalls."

Unemployable Executives

The practical realities of how organizations seeking to hire executives bound by restrictive covenants handle the restrictions has changed over the years. In prior years, prospective employers would review the terms of the restrictive covenants in the agreements of the executives they wanted to hire to determine if they were legally enforceable. If the prospective employers viewed the covenants as unenforceable, they would proceed to hire the executives with little regard for the restrictions in their covenants. If and when litigation ensued, typically the new employer would cover the cost of defending the claim by the former employer. Often, the new employer and the executive were successful in the litigation and would recover a portion of their legal costs. However, these battles were costly and time consuming, even if ultimately successful.

In recent years, prospective employers are less focused on whether the restrictive covenants are enforceable and more focused simply on whether the executive is bound by a restrictive covenant. If the executive is bound by a restrictive covenant, even one the prospective employer views is unenforceable, the prospective employer will often be more hesitant to hire the executive to avoid the time and costs associated with litigation. Thus, the executives are rendered unemployable by overly broad restrictive covenants that are not even enforceable by courts. This is unfair for the executive who still wants and needs to continue working and earning a living. Moreover, everyone in the Canadian marketplace suffers when key talent is underutilized, as further described below.

Hindering Innovation

The concerns with restrictive covenants in employment agreements were recently considered in an article titled "Ties that bind" in *The Economist*.[1] The article acknowledges how restrictive covenants can increase companies' incentives to invest in human capital, without fear the beneficiaries of the

investment will move to a competitor, taking their investment with them. However, the article weighs this slight advantage against the significant advantages associated with ensuring human capital mobility, which it distinguishes from the theft of trade secrets that deserves legal protection.

The Economist notes how human capital mobility encourages innovation because it spreads information, extends professional networks and encourages cross-fertilization. It also encourages economic efficiency by allowing people to work in jobs and for wages that suit their skills. California is provided as an example in support of this position. California has been more loath than any other state to uphold restrictive covenants and other measures that restrict the mobility of human capital. California has also benefited from high levels of capital investment and innovation, especially in areas such as Silicon Valley and Hollywood. Scandinavian countries and Israel are provided as further examples of places with lenient restrictions on human capital mobility and better records in innovation. Conversely, Germany and France are noted as countries with greater restrictions on human capital mobility and less impressive records in innovation.

The Economist further comments on how companies benefit from the free flow of human capital, whether they win or lose any particular talent war. These companies tend to have better quality human capital and make more use of performance-related rewards to recruit and retain high achievers. Even the talent-war losers gain insight into their own weaknesses and areas in which they need to improve. McKinsey & Company, a leading global management consulting firm, is identified as a leader in treating departed employees as valuable alumni, rather than enemies to be pursued in the legal system.

In fact, departing employees often move to positions that can be beneficial to their former employers, in which case the enforcement of restrictive covenants could actually be harmful to the former employer. For example, organizations that part ways with executives on good terms can benefit from those relationships when executives go work for their clients.

Finally, *The Economist* concludes by commenting how the implementation of restrictive covenants may seem to be a good idea when confronted by an aggressive competitor; however, these are seldom associated with "front-runners". Understandably, utilizing an organization's resources to restrict, what is likely inevitable, competition, reduces the availability of resources to focus on innovation and leading the industry. The resources impacted include the consumption of management time, the time of in-house legal counsel and financial resources.

Extending Severance Obligations

Organizations need to be aware that if they impose restrictive covenants on executives that effectively render them unemployable for a period of time following their departure, then they could be responsible for damages based on a period of reasonable notice

Ontario Court of Appeal — Osgoode Hall

of termination equivalent to the period in the restrictive covenant. This very issue was addressed by the court in Ontario in the case of *Dimmer v. MMV Financial Inc.*[2]

Gregory Dimmer worked for MMV Financial from May 2006 to March 2010 as a Senior Vice-President. Mr. Dimmer's employment agreement included a non-compete clause that restricted him from working for a competitor for 12 months after the cessation of his employment. Mr. Dimmer's employment was terminated without cause when he was 50 years old. Mr. Dimmer's termination letter included a reminder that he had to comply with his non-competition obligations. Mr. Dimmer complied with his non-competition obligations, which contributed to him being unable to find alternate employment until over one and one-half years later. The court awarded Mr. Dimmer pay in lieu of reasonable notice of termination assessed at 12 months. The court took into consideration Mr. Dimmer's onerous non-competition obligations in awarding Mr. Dimmer a longer notice period and stated:

> … MMV required Mr. Dimmer to agree to be bound by a non-competition agreement as a term of his employment and insisted that he abide by the agreement for one year following his dismissal. Mr. Dimmer complied. In my view, this agreement effectively eliminated any opportunity to obtain similar employment during that year and it seriously impeded his ability to obtain employment at all, even in fields beyond the reach of the non-competition agreement. This too is a factor weighing in favour of a longer notice period.

Many executives are only starting to appreciate the severe impact of these clauses on their reemployment prospects and are trying to negotiate more reasonable terms. While some executives succeed; others do not, as some organizations remain steadfast in their inclusion of unreasonable covenants. So far, the court's decision in *Dimmer* does not appear to have tempered the overuse of overly broad restrictive covenants in employment agreements. If courts truly want to restore some balance in the employment relationship, it seems they will have to consider imposing more severe consequences on organizations. Considering the devastating effect these clauses can have on executives' careers and the courts' greater willingness to award punitive damages in recent years, will courts consider awarding punitive damages against organizations that implement or seek to enforce overly broad non-competition or non-solicitation clauses in employment agreements?

Implementation Concerns

The following comments on a case where the court refused to enforce an overly broad non-competition agreement that was improperly implemented. In *Jean v. Omegachem*[3], Patrick Jean, a chemist, was offered employment with Omegachem in June 2002. The employment offer included a clause stating that Mr. Jean had to sign a confidentiality agreement and a non-competition agreement. Mr. Jean accepted the employment offer and signed the confidentiality agreement soon thereafter. However, the non-competition agreement was only presented to Mr. Jean three years later, in 2005. The agreement was for a 24-month term commencing on the cessation of Jean's employment and covered Canada, the USA and Europe. The agreement applied to certain types of producers and pharmaceutical companies. Mr. Jean refused to sign the agreement and attempted to negotiate a provision that he would be paid for the 24-month non-compete period.

One and one-half years later, Omegachem revised the agreement and presented it to Mr. Jean for his signature. The non-competition period was reduced to a 12-month term, but its geographic scope was extended–to encompass the world. Mr. Jean again refused to sign the agreement and tried to negotiate a provision that he would be paid for the 12-month non-compete period. In April 2007, the negotiations failed and Mr. Jean's employment was terminated for cause for refusing to sign the non-compete agreement.

The Quebec Court of Appeal decided that Mr. Jean's refusal to sign the non-competition agreement did not constitute cause for the termination of his employment. The clause in the employment offer requiring Mr. Jean to sign a non-competition agreement was unenforceable because the terms of the agreement were unknown. Furthermore, the non-competition agreement was unenforceable because it was overly broad in its geographic scope. Thus, Mr. Jean was entitled to pay in lieu of notice for the termination of his employment.

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Endnotes:

1 Schumpeter, "Ties that bind" *The Economist* (14 December 2013) ("*The Economist*").

2 *Dimmer v. MMV Financial Inc.*, 2012 ONSC 7257 (CanLII) ("*Dimmer*").

3 *Jean v. Omegachem Inc.*, [2012] J.Q. 762 (QCCA).