Supreme Court of Canada Voids Non-Compete Clause

By Paul Jones

The Supreme Court of Canada ruled in an employment dispute that a non-competition covenant was not enforceable, indirectly giving new guidance for franchisors about non-compete covenants with franchisees (*Shafron v. KRG Insurance Brokers (Western) Inc.*, 2009 SCC 6 (Jan. 23, 2009), available online at: http://csc.lexum.umontreal.ca/en/2009/2009scc6/2009scc6.html). The primary lesson for U.S. based franchisors is that the "blue-pencil" rule may only be resorted to in rare cases where the part being removed is trivial, and not when it is a substantive part of the restrictive covenant.

An insurance broker by the name of Shafron had sold his business and became an employee of the purchaser. The business was sold again, but Shafron received none of the proceeds. Then he left his job in Vancouver and went to work for a competitor in Richmond, just across the north arm of the Fraser River from the City of Vancouver.

Shafron had signed an agreement that stated he would not be employed in the business of insurance brokerage within the "Metropolitan City of Vancouver." The problem was that no such municipality has been incorporated. There is the "City of Vancouver," and there is the "Greater Vancouver Regional District." Yet, it was clear that Shafron had intended to be bound by some sort of restriction.

The court declared that it could not correct the error in the employer's choice of words, noting that such action would introduce a great deal of uncertainty into such contracts. In this case, the court said that the term "Metropolitan City of Vancouver" was ambiguous and could not be rewritten. The claim of the former employer for breach of the covenant was dismissed.

Impact on Franchising

Although part of the court's opinion addressed non-compete covenants in employment contracts, some of the opinion potentially is very relevant to franchising, where non-competition covenants are common. The court stated that restrictive covenants must be reasonable in scope. They may cover the geographic territory where the company presently conducts business and, perhaps, where it soon expects to do business, but they cannot cover areas where the company only hopes to do business in the future. They must be for a reasonable period of time, and they must apply only to types of activities in which the company carries on business.

Another important principle is that the restrictions in the covenant must be clear and certain. The other party (in *Shafron*, an employee, not a franchisee) must be able to easily determine what activities are prohibited.

The lessons hold in the franchising context. A franchisor's non-compete needs to be clear, certain, and reasonable — or the franchisor risks that it will be held invalid. Obviously, it is important to ensure that the geographical scope of the covenant is defined using the correct legal names of the areas being referenced. But the more difficult problems are usually in defining the types of businesses and the business relationships that are restricted. For example, what is a clear and reasonable restriction with respect to a franchise system operating sushi kiosks? If the covenant said that a former franchisee could not own or be employed in any restaurant, that might be a clear restriction, but would it be reasonable? If the covenant prohibited owning a business that served sushi, what about an upscale Japanese style restaurant where sushi was just one of the dishes? A reasonable and clear restriction for a sushi kiosk might be to not own or operate, directly or indirectly, a business whose primary source of income is the sale of sushi and/or sashimi.

Properly drafted non-competition covenants are enforceable in Canada.

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Recession

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through a thicket of legal issues. Here are some scenarios franchise counsel may need to confront.

Inability to Pay. How will the franchisor handle franchisees' failure or inability to pay? To what extent will the franchisor be willing to work with franchisees that are in financial difficulty? To what extent will the franchisor want to terminate at least some franchisees to maintain pressure on others to keep paying?

Financial Concessions. If the franchisor is prepared to make financial concessions on an individual basis, a number of issues will arise. In many instances, the franchisor will want to preserve the confidentiality of concessions due to concern that others will then ask for similar concessions. But how realistic is it to expect that confidentiality agreements will be effective? Can they be structured to enhance effectiveness (loss of benefits if they become known)? Also, bear in mind the disclosures about "gag agreements" under the new FDD guidelines. In connection with financial concessions, will debts be forgiven or deferred, and how will deferrals be handled (*e.g.*, separate promissory notes)? Should the franchisor try to: a) obtain releases to cut off potential claims, and/or b) enhance collectibility of remaining payment obligations through personal guaranties, security interests, etc.? How will selective concessions comport with the franchisor's obligations under the anti-discrimination

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