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The future of unconventional restrictive covenants

Recent B.C. ruling adopts a functional, English-based approach

Matthew Sammon

The recent case of *Rhebergen v. Creston Veterinary Clinic Ltd.* [2014] B.C.J. No. 417 of the B.C. Court of Appeal, provides a useful analysis of the state of the law regarding unconventional restrictive covenants, as well as an indication as to where the law in this area may be moving.

The conventional or classic restrictive covenant is well known: it is a direct promise by a departing employee not to compete with his or her former employer, and/or not to solicit the clients or employees of the former employer. The law governing these covenants is equally well-settled: covenants in "restraint of trade" are presumptively void, unless they can withstand scrutiny under a strictly-applied "reasonableness test" established by the Supreme Court of Canada *in J. G. Collins Insurance Agencies Ltd. v. Elsley Estate [1978] 2 S.C.R. 916*.

However, what about covenants that do not restrict competition outright, but instead impose financial burdens on the departing employee if he or she competes? For example, does a clause that requires an employee to repay training costs in the event he or she competes amount to a covenant in restraint of trade? What about a contract which provides for the forfeiture of deferred bonus amounts, or repayment of stock options benefits, in the event that a departing employee competes within a defined period?

The law governing these sorts of employment covenants is much less clear. In fact, there is a line of cases in Ontario, stemming from the 1941 decision in *Inglis v. The Great West Life Assurance Co.* [1941] O.J. No. 366, which suggest that covenants that impose a financial burden on a competing former employee (by withdrawing a benefit or imposing a cost), but do not restrict competition *per se*, are not covenants in "restraint of trade" at all (and thus are not subject to the reasonableness test in *Elsley*). For example, in *Nortel Networks Corp. v. Jervis* [2002] O.J. No. 12, the court found that a covenant requiring the employee to repay profits he had earned through the exercise of stock option grants (over $600,000) because of post-employment competition was not a covenant in "restraint of trade" at all.

The formalistic reasoning in these Ontario cases seems problematic. There is arguably little difference between a clause restricting competition per se and one imposing significant financial burdens on the departing employee if he or she chooses to compete. The practical impact may be the same.

The B.C. Court of Appeal considered this issue at length in *Rhebergen*. In sum, the court rejected the formalistic approach adopted by the Ontario authorities and instead adopted a "functional" approach to assessing unconventional restrictive covenants.

The facts were straightforward. Stephanie Rhebergen entered into a three-year employment contract with a veterinary clinic. The clinic did not want to invest in her training and introduce her to its customers, only to see her start a competing practice in the same small community. Therefore, in exchange for hiring and training her, the veterinary clinic required

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Frustration of contract not just for employers

Kumail Karimjee

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With the end of mandatory retirement, employees are working longer, or at least planning to. However, with aging comes a marked increase in the prevalence of disability. According to Statistics Canada's *Participation and Activity Limitation Survey 2006*, 33 per cent of Canadians aged 65 to 74 had a disability. The reality is that employees over the age of 65 face a heightened risk of developing physical and mental limitations which may interfere with continued productive employment.

What happens if an employee who intended to work to 68 or 70 is unable to do so for health reasons? Traditionally, many employees would simply resign because their health has not allowed them to work as long as they may have wished. In effect, they would be forced to retire. However, where it is an injury or disability that renders ongoing employment impossible, even at an advanced age, an employee may assert frustration rather than simply "resign" or wait for an employer to act. An older employee who is slowing down and unable to perform due to disability, even in the absence of a long-term leave, may be able to show that continued employment is impossible. The reason that an employee may want to do so is that an exit on the basis of frustration, even if initiated at the employee's request, will give rise to an entitlement to *Employment Standards Act* (ESA) termination and severance pay. For a long-service employee, this will be a maximum of 34 weeks or almost eight months of pay.

Employees rarely assert frustration themselves when they become unable to perform. In fact, in the employment context, the doctrine of frustration is typically used by employers as a defence to wrongful dismissal claims brought by employees. Within this context, the general principles are well known. Frustration of contract arises when unforeseen circumstances not addressed in the contract result in a radical change in contractual obligations. In considering whether or not an employment contract is frustrated on the basis of disability, the test to be applied is whether there is no reasonable likelihood of the employee being able to return to work within a reasonable time. In considering whether or not frustration is made out, a court will consider the length of the employee's absence, the nature of the employee's position, whether or not long-term disability benefits are available to the employee, accommodation efforts and most importantly, the medical evidence regarding the employee's prognosis for a return to work within the reasonably foreseeable future.

Frustration arises by operation of law, not the action of any party. It is a state of being, and by extension the ability to assert it and the onus of proving it does not automatically rest with the employer or the employee. As such, an employee forced to stop working due to health reasons may assert that the employment contract has been frustrated even where an employer wishes to maintain the employment relation.

I am not aware of any civil cases in which employees have asserted frustration; however, there are a few examples in the grievance arbitration context. In *St. Joseph's General Hospital v. Ontario Nurses' Assn. (Glynn Grievance)* [2006] O.L.A.A. No. 155, an employee was held to be entitled to ESA severance pay arising from the frustration of the employment relationship in the absence of an active decision to terminate by the employer. Arbitrator Randall found that the grievor's employment contract was frustrated by her injuries, and thus deemed terminated, despite no positive action on the part of her employer to terminate her employment. The arbitrator also found that the grievor was entitled to severance pay on the plain wording of relevant provisions subsection 63(1)(a) of the ESA, which provides that an employer severs the employment of an employee if it "is unable to continue employing the employee." The grievor's injuries made the employer unable to continue to employ the employee. The same reasoning should apply in the common law employment context.

The ESA provides for basic minimum entitlements and should be liberally interpreted. It is only the exceptional case where an employee whose employment has ended involuntarily is denied ESA notice and severance. Severance pay in particular has been recognized as an earned benefit that compensates employees for their past service and for their investment in the employer's business (*Rizzo & Rizzo Shoes Ltd. (Re)* [1998] 1 S.C.R. 27). Where an older employee cannot keep up, and is forced to stop working for health-related reasons, frustration may be asserted by the employee so that termination and severance pay is paid on departure in recognition of the employee's long service and investment in the employer's business.

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that Rhebergen promise to pay the clinic a fixed amount if she "set up a veterinary practice" in the community or within a 25-mile radius.

The issue before the appeal court was whether the clause was in restraint of trade at all (and thus subject to the reasonableness analysis required by *Elsley*), and whether, if it was a restraint, it should nevertheless be enforced. The members of the court differed on whether the clause should be enforced, but all agreed that the covenant was in restraint of trade, and therefore subject to the reasonableness test in *Elsely*. Justice Peter Lowry wrote detailed reasons analyzing the state of law regarding unconventional restrictive covenants, which was adopted by the majority (he dissented on the issue of whether the covenant was reasonable).

Justice Lowry noted that there are two strands of authority in Canada: a functional approach and a formalist approach. The formalist approach, reflected in a number of the Ontario cases, considers a covenant to be a restraint of trade only if it is structured as a prohibition against competition. The functional approach, adopted in the English jurisprudence, considers the practical effect of the covenant, and not solely its form.

After a thorough review of the authorities, Justice Lowry found that the functional approach should be preferred, and that the covenant was a restraint of trade.

"In my view, the functionalist approach established in English law is to be preferred as the legal basis for determining whether clauses that burden employees with financial consequences, whether by payment or forfeiture, they would not otherwise have for engaging in post-employment competition constitute a restraint on trade," he wrote. "In the words of Lord Wilberforce, it is a matter of the effect of the clause in practice over its form."

From a common sense perspective, there seems much to commend the practical approach of the B.C. Court of Appeal. The logical and practical approach in *Rhebergen*, and its solid foundation in the English authorities, suggest it may well ultimately be adopted in Ontario and elsewhere in Canada. In the recent Ontario case of *Levinsky v. Toronto-Dominion Bank* [2013] O.J. No. 4118, Justice David Brown appeared to endorse a functional approach to analyzing an unconventional restrictive covenant (although in that case, he found that the covenant in question as not directed, in form or in impact, at restricting competition). In the future, given the added weight of the *Rhebergen* decision, I expect that subsequent Ontario courts will also follow suit.

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