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Restrictive Covenants: A Primer for High Tech and Other Employers

With the explosion of high tech companies in Canada has come a shortage of talented and experienced employees to work for those companies. Whichever high tech centre your company is located in, the chances are that the hiring and retention of experienced employees is an ongoing challenge.

If your offer is right, it can be easy enough to entice experienced employees from your competitors. But what are the restrictions facing both you and your incoming employees if you do so? At what point does simple recruiting lead to a claim against your company for breach of restrictive covenants? On the other hand, what recourse do you have if another company seems to be targeting some of your employees for their special skills or knowledge? Can you prevent competitors from taking advantage of the years of training and specialized knowledge that you have invested in your employees?

As a general rule, a departing employee can compete with her former employer. However, that will not be the case where: (i) the employee owes a fiduciary duty to the former employer; (ii) the employee misuses the former employer's confidential or proprietary information; or (iii) there is a restrictive covenant which validly limits the employee's post-employment conduct.

For those companies interested in protecting their confidential information, clients or employees, the solution is often to require employees to sign a Confidentiality Agreement, a Non-Solicitation Agreement and a Non-Competition Agreement at the time of hiring. But are those agreements effective? A review of recent Canadian court decisions will summarize the courts' views on this matter.

Using Restrictive Covenants to Protect Your Company from Departing Employees

(i) Confidentiality Agreements

Many employers have their employees sign a Confidentiality Agreement, a Non-Solicitation Agreement and/or a Non-Competition agreement at the time of hiring. Often the agreements are "cookie cutter" templates to which little thought is given by the employer. However, if there is one thing that the Canadian courts have stressed again and again with respect to the use of restrictive covenants, it is that they should be carefully drafted with respect to the particulars of each employee.

What do I mean by this? Most high tech companies have two primary concerns when it comes to departing employees. First, they want to protect their confidential and proprietary information, be it source code, hardware design or something else. Second, for those companies that sell their product to other companies or to the public, they want to keep their departing employees from soliciting those customers. Sometimes there is a similar solicitation concern, in that employers want to ensure that departing employees are not also soliciting their old co-workers. It can be an enormous blow to a company to see most members of a development group head out the door within a few weeks of each other, often to a direct competitor.

Oftentimes, most of the company's concerns will likely be served with a well-drafted Confidentiality Agreement. Such an agreement should, at a minimum, restrict the employee from divulging confidential information during the time of employment or at anytime thereafter. Preferably, it will define confidential information in the context of the company's business. Where the employee may be involved in the design or development of proprietary materials, it is a good idea to get the employee to list in the agreement all design or development work done by the employee before commencing her current employment. That way, it is very difficult for the employee to later try to argue that a particular piece of design or development work was done independently and without using company knowledge or resources.

It should be pointed out that in some of the states in the United States, the doctrine of "inevitable disclosure" has recently arisen. What does that mean? Well, take the case of an employee who spends a significant amount of time developing a highly technical product at one company, and then departs for another company where he appears to be doing similar or identical development work. In these cases, some of the American courts have determined that even if the employee was subject to a Confidentiality Agreement and even if the employee was trying to be true to the agreement, disclosure of at least some confidential information would be inevitable. The doctrine of "inevitable disclosure" does not appear to have arrived in Canada yet, although the similar "springboard

doctrine" has been cited on rare occasion in Ontario, and both this doctrine and the American equivalent will likely be used with increasing frequency in Canadian breach of confidence litigation in the coming years.

Is a Confidentiality Agreement enough? What if your now-departed employee is approaching your customers and you strongly suspect that the employee must be using confidential information in order to compete with you? Or what if your terminated employee is soliciting some of your current employees and you have heard that they are going to or forming a competitor that does development work in the same area as your company? Is a promise to honour confidential information enough? Can employees help but to disclose confidential information, even unintentionally, if they are working in the same area in which they used to work for you?

(ii) **Non-Solicitation Agreements**

To get around those concerns, it is often helpful to also have your employees execute a Non-Solicitation Agreement at the time of hiring. At a minimum, it should prohibit the solicitation of current and prospective customers of your company, as well as the solicitation of your employees. But the Canadian courts will not necessarily enforce Non-Solicitation Agreements, even where they have been agreed to. In order to ensure enforceability, you must make sure that your agreement is **REASONABLE**. I highlight the word reasonable, because it comes up again and again in Canadian court decisions, in the context of both Non-Solicitation Agreements and Non-Competition Agreements.

For example, if your agreement aims to prevent solicitation of customers and/or employees for a period of several years, the courts are likely to take the position that the agreement is void and unenforceable, on the basis that the length of non-solicitation is unreasonable in any commercial context. As a result, employers should determine at the time that Non-Solicitation Agreements are signed, exactly which non-solicitation provisions are reasonable in the context of each individual employee. For example, the courts are more likely to uphold against a salesperson, a non-solicitation clause

preventing that individual from soliciting his or her former clients. Likewise, the courts are more likely to uphold against a lead product developer, a non-solicitation clause preventing that individual from soliciting his or her former co-workers. Additionally, some courts have imported the concept of ‘geographic scope’ issue from Non-Competition Agreements into Non-Solicitation Agreements.

But is a Confidentiality Agreement and a Non-Solicitation Agreement enough? What if your employee is so senior that he would be unable to work for any competitor without inadvertently making use of your confidential information? What if her knowledge of the industry is inherently wrapped up with her knowledge of your company’s finances, products, customers and so on?

(iii) Non-Competition Agreements

Many companies insist on the signing of a Non-Competition Agreement to prevent against this type of problem. However, is a Non-Competition Agreement really necessary? Under Canadian case law, if your employee is a fiduciary, he will automatically be subject to certain fiduciary obligations arising out of his employment, such as a duty to act in good faith and not expropriate your corporate opportunities for his own benefit. This was recently confirmed by the Ontario Court of Appeal in the case of *ElectroSource v. Felker*. Those fiduciary obligations continue beyond the termination of employment. The definition of a fiduciary includes corporate officers, directors and top management and, in some instances, extends to key personnel. In instances where you clearly know that your employee is a fiduciary, a Non-Competition Agreement may not be necessary. However, in many instances you will not be certain whether your employee will meet the definition of a fiduciary and you may want to insist upon a Non-Competition Agreement. In other cases, you may want the certainty of spelling out for your employee exactly which competitive practices are acceptable and which are not. Again, the trick to enforceability is to ensure that your agreement is **REASONABLE**.

When Non-Competition Agreements are reviewed by the Canadian courts, they are struck more often than they are

enforced. The primary reason is that the courts do not like anything which appears to be a “restraint of trade”. They do not like to prohibit employees from earning a living and they will often take the position that those agreements which try to do so are void and unenforceable. Where Non-Competition Agreements are overly broad as to the duration of non-competition, the geographical scope of the non-competition or the definition of non-competition, they will not be enforced. Only a well drafted Non-Competition Agreement with reasonable terms will prohibit an employee from competing with a former employer, while at the same time permit that employee to undertake other work which the employee is qualified to do.

In trying to get around possible “restraint of trade” arguments, many companies have used Non-Competition Agreements which provide for an ever-decreasing choice of duration and/or geographic scope, where it is suggested that the court determine which of several options should be enforceable. These agreements have originated in the United States and, in at least one instance, a Canadian court has found them to be “void for uncertainty”. Likewise, many companies use Non-Competition Agreements which provide that the individual who will be subject to a non-competition provision, will be given pay in lieu of notice through the period of non-competition, thus avoiding the “restraint of trade” argument. There has been recent caselaw in Ontario however, where a judge found that even though a salesperson was to receive 12 months pay in lieu of notice in exchange for agreeing to not compete for 12 months, the salesperson would effectively be unable to carry on business after the 12 month period, as he would be away from his job for too long to be an effective salesperson in that particular industry. While the underlying principle behind this type of clause makes sense, clearly the courts have now indicated that employers must look carefully at the circumstances of the individual employee before resorting to this type of agreement.

There is another reason for requiring your employees to execute a Non-Competition Agreement, and that is the “fear factor”. Many employers are rightly of the view that in the vast majority of cases, an employee who has signed a Non-

Competition Agreement will not question it and, if push comes to shove, will honour it. While there is nothing wrong with proceeding in that fashion, employers should always keep in the back of their minds the fact that Non-Competition Agreements which are: (i) a restraint of trade; (ii) overly broad; or (iii) not tailored to the specific circumstances of the signing employee, are unlikely to be enforced in those instances where the employee chooses to dispute the terms in court.

In summary, employers concerned about departing employees should strongly consider making their employees sign a Confidentiality Agreement and, in many instances, also a Non-Solicitation Agreement. Only in some circumstances should a Non-Competition Agreement be insisted upon. In those cases, employers should draft the Non-Competition Agreement as reasonably and as non-restrictively as possible, in order to increase the odds that it will be enforceable.

The Flip Side – How to Avoid Liability When Hiring Employees who are Subject to Restrictive Covenants

What if the tables are turned and you are interested in hiring some employees who are subject to restrictive covenants with their former employers. Should you hire them? If so, are there steps that you can take to try to minimize your exposure to a potential claim from the former employer?

You have just hired a great new employee with a wealth of knowledge that will assist with your new product development. Then a letter arrives from a law firm, warning both you and your new employee that a lawsuit, and possibly even a motion for an injunction, will be commenced if there is any evidence that the employee is misusing confidential information or the like. What do you do?

When you hire new employees, it can be helpful to insert a clause in their employment agreements which confirms that by joining your company, they will not be breaching any restrictive covenants with a former employer or other entity. It is also helpful to have a written company policy which

confirms that your company is not interested in using the confidential information of other companies and which outlines procedures to guard against the inadvertent misuse of confidential information from other companies. While neither of these steps can guarantee protection from litigation, they do act as a first line of defence if a lawsuit is commenced.

If you are hiring an individual to work on the development of a particular product, make sure that you try to understand at the time of hire whether your company's development protocol is the same as or different than that of her prior employer. If it is the same and you still want to hire her, you can either make a reasoned decision to hire her into that position with full knowledge of the possible consequences or you can hire her for her general strengths and make sure that she works on something different than that which she did for her former employer. Additionally, if litigation is commenced, you may successfully defend on the basis that the restrictive covenants to which she was bound with her former employer are too restrictive and accordingly, are not enforceable.

Additionally, ensure that your employees are all aware that communications by email and other documentable means can leave a "paper trail" which can be harmful if litigation is commenced and all "documents" are required to be produced. They should be aware of the potential for disclosure of solicitation emails to customers and prior co-workers, which may be in breach of a restrictive covenant or fiduciary obligations.

If you hire an employee whom you suspect holds fiduciary obligations to her former employer, try to safeguard your company against claims of improper solicitation and competition by keeping that new employee from soliciting business and co-workers, at least for several months, whenever possible. While there is not necessarily anything wrong with former customers and co-workers of that person following them to your business, there is a lot that may be wrong with a direct solicitation of those customers and employees by your new senior employee. The few months' wait that is required to lessen the chance of a successful claim against your company is generally worth its weight in the long run.

Conclusion

While there is a proliferation of litigation in the United States high tech industry in relation to these issues, the area is still in its infancy in Canada. It is a tricky area with numerous potential pitfalls for both employers and employees and, as always, the best way to avoid those pitfalls is to seek legal advice before problems arise. Fraser Milner Casgrain LLP has employment law and technology law lawyers in each of its offices and is available to assist with any of these issues.

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