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## Supreme Court of Canada rules ambiguity fatal to non-competition clause

In January 2009, the Supreme Court of Canada released its decision in *Shafron v. KRG Insurance Brokers (Western) Inc.* (2009). The court ruled that that an ambiguous non-competition clause could not be relied on by the employer to restrict the competing activities of a former employee. The Supreme Court refused to uphold the non-competition clause by using the legal techniques of severance (limiting or removing the illegal part of a contract) or rectification (correcting an error in the agreement). This illustrates that courts will rarely use their judicial toolbox to fix and enforce unclear restrictive covenants in employment agreements.

In 1987 Shafron sold his insurance agency to KRG Insurance Brokers Inc. for \$700,000. KRG continued to employ Shafron for a number of years. The company used a series of employment contracts, all of which included non-competition clauses in substantially the same form as the following:

### Non-Competition

12. Shafron shall not, upon his leaving the employment of the Corporation [KRG Western] for any reason, save and except for termination by the Corporation without cause, for a period of three (3) years thereafter, directly or indirectly, carry on, be employed in, or be interested in or permit his name to be used in connection with the business of insurance brokerage which is carried on within the Metropolitan City of Vancouver.

The employment relationship ended with the expiry of Shafron's final contract in December 2000. In January 2001, Shafron started work as an insurance salesman with Shaw Insurance Agency Ltd. in Richmond, British Columbia. KRG sued Shafron, claiming he was in breach of the non-competition clause in his employment contract with KRG.

The trial judge dismissed KRG's action, finding that the term "Metropolitan City of Vancouver", as used in the non-competition clause, was ambiguous in that it had no legal or judicial meaning. As a result, the non-competition clause could not be enforced.

On appeal, the B.C. Court of Appeal held that the ambiguity could be resolved by using the doctrine of severance. The Court of Appeal "read down" the term "Metropolitan City of Vancouver" to mean the City of Vancouver, the University of British Columbia Endowment Lands, Richmond and Burnaby. The appeal court held that the non-competition clause - as interpreted and limited by the court - was reasonable and enforceable. Shafron appealed this decision to the Supreme Court of Canada ("SCC").

## RESTRICTIVE COVENANTS AND REASONABLENESS

As a general rule, restrictive covenants, such as non-competition clauses, are void because they interfere with an individual's freedom to trade. However, the law also recognizes that parties have freedom to contract on the terms they choose. In attempting to balance these competing interests, Canadian courts have carved out an exception to the general rule: i.e. if the restrictive covenant is reasonable, in terms of its geographic scope and the period of time for which it is effective, it will be upheld.

The SCC agreed with the trial judge that there was no legal or judicial meaning for the term "Metropolitan City of Vancouver". The geographic scope of the restrictive covenant could not be determined and could not be found to be reasonable. The SCC then considered whether the Court of Appeal was correct in applying the doctrine of severance to save the provision.

## THE DOCTRINE OF SEVERANCE

The doctrine of severance refers to two methods of removing illegal features of a contract to render the contract enforceable: (a) "notional severance" and (b) "blue-pencil severance". Notional severance refers to reading down an illegal provision of a contract to render it legal, while blue-pencil severance refers to striking out, or severing, the illegal portion of a contract, while leaving the legal portions intact.

### **(a) No place for notional severance in restrictive covenants in employment contracts**

The SCC stated that notional severance can only be used where there is a "bright-line test" for what is legal. The term "bright-line test" refers to the definitive line between what is legal and what is illegal in a contract. The SCC cited *Transport North American Express Inc. v. New Solutions Financial Corp. (2004)* ("*Transport*") in which the parties inadvertently contracted for an interest rate that exceeded the criminal rate prohibited by the *Criminal Code*. There was no evidence that the parties intended to contravene the Code, or to engage in loan-sharking. The court was thus able to infer that the intention of the parties was to charge the highest possible *legal* rate of interest. The court was able to apply notional severance to read down the illegal interest rate to a legal rate because there was a bright-line between what was legal and illegal.

In applying the reasoning in *Transport* to restrictive covenants in employment contracts, the SCC found that there is no objective bright-line test that can be applied in all cases to determine what is reasonable. A court that applies notional severance to a non-competition clause simply rewrites the provision in a manner that it subjectively believes to be reasonable. This would have the effect of creating uncertainty in the law as to what may be considered "reasonable" in any specific case. As a result, the SCC held that notional severance has no place in the interpretation of restrictive covenants in employment contracts.

### **(b) Blue-pencil severance not applicable**

The SCC also found that "blue-pencil severance" was not appropriate. In spite of the employer's argument that the word "Metropolitan" should be severed so as to leave only the "City of Vancouver" (which does have a legal meaning) the SCC was guided by the decision in *Canadian American Financial Corp. (Canada) Ltd. v. King (1989)*, which states:

"The courts will only sever the covenant ... if the obligation that remains can be fairly said to be a sensible and reasonable obligation ... such that the parties would unquestionably have agreed to it without varying any other terms of the contract."

The SCC ultimately rejected the use of blue-pencil severance because there was no evidence that KRG or Shafron would "unquestionably" have agreed to remove the word "Metropolitan" without varying any other term of the agreement.

## RECTIFICATION

Finally the SCC considered whether the ambiguity could be resolved by using rectification. Rectification is used by the courts to reflect and restore what the parties' actual agreement was, were it not for an error in the written agreement.

The SCC said the three requirements for rectification, as stipulated in its decision in *Performance Industries Ltd. v. Sylvan Lake Golf & Tennis Club Ltd.* (2002), must be met. First, the existence and content of an inconsistent prior oral agreement must be shown. Second, it must be shown that the party seeking to uphold the terms of the written agreement knew, or ought to have known, about the lack of correspondence between the written document and the oral agreement, in circumstances amounting to fraud or the equivalent of fraud. Third, the precise form in which the written instrument can be made to express the prior intention must be readily ascertainable.

The SCC held that KRG was not able to show a prior oral agreement that would explain the meaning of the term "Metropolitan City of Vancouver." Also there was no indication that the parties agreed on a reasonable geographic area and then mistakenly included something else in the contract. In light of this, the SCC refused to invoke rectification to uphold the provision. It went on to restore the trial judgment which held that the restrictive covenant was unreasonable due to ambiguity, and was therefore unenforceable.

### In Our View

The courts traditionally scrutinize restrictive covenants in employment contracts more strictly than they do restrictive covenants in agreements for the sale of a business. This difference is partly justified on the basis that the vendor of a business will generally receive a payment for goodwill, while an employee leaving a job will not. The goodwill payment the vendor receives compensates for the custom of the business remaining with the purchaser. If the courts denied the vendor the right to assure the purchaser that he or she would refrain from competition, it might be impossible for the vendor to sell the business. As a result, the courts have generally taken a less strict view of what is reasonable for restrictive covenants in agreements for the sale of a business.

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