Don't Let the Door Hit You on the Way Out

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Protecting your business with a restrictive covenant

In the insurance industry, a brokerage relies on personal relationships and contacts as the foundation of its business. Anything that might jeopardize that foundation needs protection. As a result, brokerages often require their brokers to enter into an employment agreement with them. Usual terms to include in such an agreement are restrictive covenants, preventing the broker from competing with the employer or from soliciting the employer's business on termination of the broker's employment.

A brokerage recognizes that in representing its business to clients, brokers often develop a close personal relationship; for all intents and purposes, the broker is seen as the one taking care of the client's insurance needs. These clients will often be inclined to follow this broker upon his or her departure from the brokerage.

In addition to protecting a brokerage from losing business to ex-employees, restrictive covenants also protect a brokerage from a former owner who has sold his business to the brokerage and then establishes a competing brokerage. But the focus of this article will be on restrictive covenants as they apply to an employer/employee relationship.

Restrictive covenants in employment agreements take a couple of forms. They might be covenants not to compete for a particular period of time and in a particular area. Or they might include provisions not to solicit clients of a business for a particular period of time and in a particular area. Whatever form the covenant takes, the problem with this defensive strategy for protecting a brokerage business is that unless the restrictive covenant is carefully drafted and the circumstances are such that a restrictive covenant is appropriate, it will likely be found to be unenforceable.

LEGAL PRINCIPLES

All restraints of trade are contrary to public policy, which mandates that parties have the freedom to contract. The public has a general interest in free and open competition. Thus the courts generally look upon restrictive covenants with suspicion. However, there are exceptions: if, for example, a restraint is reasonable in the context of the interests of the parties concerned and in the public interest, it will be upheld. Restrictive covenants are construed more strictly against an employer than against a seller, and they are more often construed in favour of a purchaser under a contract for the sale of a business.

Competing interests are involved when it comes to restrictive covenants in an employer/employee

relationship. The employer has a need to protect its business while an employee has a right to earn a living. The courts are often called upon to determine the dividing line as to what is reasonable and what is not.

Of the different restrictive covenants, the covenant preventing or restricting competition receives the closest judicial scrutiny. The following questions are usually canvassed when analysing the validity of such a covenant:

Does the employer have a proprietary interest requiring protection?

An employer has the right to protect its business. This includes restricting or eliminating the solicitation of clients by former employees or preventing such employees from acquiring a business opportunity that is rightfully the employer's. It may also preclude former employees from working in a competing business for a period of time under certain circumstances.

Is a restraint reasonable in time and space?

The length of time to protect an interest cannot be overly long or cover too broad an area.

Is the activity to be restricted defined in terms that are too broad?

An employer must be precise in the activity it seeks to restrain. It cannot set out a broad restriction preventing an employee from participating in a business that competes generally with that of the employer.

Is the restrictive covenant reasonable with respect to the public interest?

A court must look at the overall principle of restraint of trade to determine if the restrictive covenant is reasonable.

Several important cases in recent years involve restrictive covenants specific to the insurance brokerage business. The most recent case was a Supreme Court of Canada decision about the geographic area covered by a restrictive covenant, *Shafron v. KRG Insurance Brokerage (Western) Inc.*[1] This article will review two decisions by Courts of Appeal and the KRG decision to determine how the courts apply general principles governing restrictive covenants. It will conclude by offering drafting suggestions on what should be included in restrictive covenants applicable to an insurance brokerage business.

CASE AUTHORITIES

The case of *Valley First Financial Services Ltd. v. Trach et al*[2] involved an employee who left his employment at an insurance brokerage business to start one of his own. Although the court found the employer did have a proprietary interest in the clients being solicited and the time and area restrictions were reasonable, the restrictive covenant was still held to be

unreasonable. The court concluded the terms "financial services" and "general insurance," which described the field of services and solicitation for which competition was restricted, were too broad. The employee had only worked in the employer's group benefits area, whereas the services set out in the restrictive covenant covered a very broad range. The employee never provided some of the restricted services while employed at Valley First.

A more recent decision on restrictive covenants in the insurance context is the case of *H.L. Staebler Company Limited v. Alan et al*,[3] a June 2008 decision by the Ontario Court of Appeal. It is an important decision, in that the brokerage, Staebler, applied for leave to the Supreme Court of Canada after it lost before the Court of Appeal. Leave to appeal was denied on Feb. 19, 2009, thereby making the case a strong precedent in this area of the law.

Staebler involved two insurance brokers who resigned and began working for a competing brokerage. As a result of being solicited by these brokers, a substantial number of Staebler clients transferred their business to the competing brokerage. The two brokers had signed an employment contract with Staebler containing a clause that covered restrictions on termination of employment. This clause read as follows: "In the event of termination of your employment with the company, you undertake that you will not, for a period of two consecutive years following the said termination, conduct business with any clients or customers of H.L. Staebler Company Limited that were handled or serviced by you at the date of your termination."

The trial judge found that although the clause prohibited the former employees from conducting business with those clients of Staebler which they handled, it did not stop them from acting as insurance brokers selling insurance with a competing insurance brokerage. The judge concluded the restriction was reasonable because it did not prevent employees from obtaining new employment; moreover, this new employment was not contingent on them bringing clients with them to their new employer. He further held that the restrictive covenant's two-year time period fell within the industry norm.

The Ontario Court of Appeal overturned the trial judge's decision. In determining whether the covenant restricting competition was reasonable, the Appeal Court referred to the leading Supreme Court of Canada decision *Elsley Estate v. J.G. Collins Insurance Agencies Ltd.*[4]. The Supreme Court ruled non-competition clauses were justifiable only in exceptional circumstances, such as where a non-solicitation clause would not be sufficient to protect an employer's business interests.

The appellate court in *Staebler* considered the questions outlined previously in this article. Staebler's proprietary interest was a given. As to the limitation in the clause, although the covenant had a two-year time limit, it had no geographical limit. In interpreting the breadth of the clause, the court found these employees could not conduct business with former clients no matter where the employees were located, even if it was elsewhere in Canada. In addition, the appellate court found the prohibition against doing "business" with Staebler's clients and customers was too broad. The decision notes that if the employees had left the field of commercial insurance and undertaken any other services for these clients, this clause could still have application. Thus, based on the lack of a geographic limit and the blanket prohibition on conducting business, the appellate court held that the restrictive covenant was unenforceable.

The activity to be restricted must be specific and clear ... The services being restricted can not be described, for example, as "general insurance."

Finally the court considered whether the covenant was unenforceable as being against competition generally, and not limited to just preventing solicitation of clients of the former employer. Here the court found that it was the industry norm for employees of brokerages to have close personal relationships with brokerage clients with whom they dealt. It concluded those relationships were not exclusive and these employees had no special knowledge of or influence over the Staebler business. This is in contrast to the Supreme Court's decision in *Elsley*, in which the employee in question had control of the employer's business.

In finding the non-compete clause to be unreasonable, the Ontario Court of Appeal referred back to the *Valley First* decision and noted suitably restricted non-solicitation clauses would likely be found reasonable for sales people in the insurance brokerage industry, whereas non-competition clauses would not be suitable in such circumstances.

The last case, the *KRG* decision, involved a fairly discrete issue arising out of an employment agreement. There was a clause in the agreement headed "non-competition" that prohibited the employee, Morley Shafron, from becoming employed after termination with another insurance brokerage for a period of three years and within a designated area. KRG's action was dismissed at trial: the judge found the description of the designated area — "Metropolitan City of Vancouver" — to be unclear and thus the restrictive covenant was unreasonable.

The B.C. Court of Appeal reversed this decision, interpreting the area to include the City of Vancouver and certain contiguous municipalities. But the Supreme Court restored the trial decision, finding that in order for a restrictive covenant to be enforceable, its terms had to be unambiguous. In *KRG*, the ambiguity could not be resolved and thus the restrictive covenant was on its face unreasonable and unenforceable.

SUGGESTIONS

These cases demonstrate that great care must be taken in drafting restrictive covenants in employment contracts to protect the business of an insurance brokerage. The following points should be kept in mind:

• Be specific on the area to be covered. It should not be overly broad.

• As for time periods, two years is the maximum. The trial judge in the *Staebler* case concluded that the practice in the insurance brokerage business of a client becoming comfortable dealing with a new broker was approximately two years.

• The activity to be restricted must be specific and clear. As illustrated in the above cases, the services being restricted cannot be described, for example, as "general insurance." In fact, in the *Staebler* case, although the restricted activity was fairly specific to clients serviced by the brokers, the Ontario Court of Appeal found a way around that by postulating that if the brokers had left the field of commercial insurance in which they were servicing the clients, they would still be prohibited from dealing with them for other insurance services because of the wording of the restrictive covenant. This underlines the requirement for being specific.

• Unless there are exceptional circumstances, a restrictive covenant that seeks to limit competition is likely unenforceable in most instances; a non-solicitation clause should be used instead. The only type of exceptional circumstance that would appear to apply would be if the employee were a fiduciary and a senior employee controlling the overall business of the brokerage.

FINAL COMMENTS

In the context of a standard broker departure from a brokerage — i.e. the broker's departure is followed by the departure of some of his or her clients from the brokerage — a non-solicitation clause is often toothless because of the nature of the connection brokers have with their clients. As a result of this broker/client relationship, it is likely that a broker would not have to engage in any form of solicitation to have clients join the broker on departure, damaging the business of the brokerage in the bargain.

There is still a place, however, for non-competition clauses to apply to employment agreements prepared by insurance brokerages for their protection. The non-competition clause in *Staebler* was close to being workable, but it was marred by having no geographical limit. In addition, the Court of Appeal ruled a prohibition against doing business with a particular group of clients in the restraining period was too broad. If the services provided to the client by the broker are specifically defined, it is arguable that such a non-competition clause would be found to be reasonable in the future. Just to be safe, however, a non-solicitation clause should always be included in employment agreements with brokers. ≡

1 2009 SCC 6, [2009] B.C.W.L.D. 700 ("KRG")

2 2004 BCCA 312, 30 B.C.L.R. (4th) 73 (C.A.) ("Valley First")

3 2008 ONCA 576, 2008 C.L.L.C. 210-034 (C.A.), leave to appeal refused 2009 CarswellOnt 816 (S.C.C.) ("Staebler")

4 [1978] S.C.R. 916 ("Elsley")