

COMPETITION BY THE DEPARTING VENDOR

I. Introduction

In what circumstances is the vendor of a business entitled to either set up a new business or obtain employment in competition to the purchaser?

In many cases this issue is complicated when the vendor of the business agrees to be employed by the purchaser following the sale of the business. Then, some time later, the vendor leaves that employment and enters into competition with his or her former business.

Not surprisingly, the law treats a vendor in such circumstances differently from an ordinary employee who seeks to compete with his or her former employer. Further, there are some legal remedies which may be available to the purchaser/employer that may not apply in the ordinary employment context.

A. Restrictive Covenants

It is well-established that contracts of employment which contain a restrictive covenant are viewed as prima facie offensive, as such contracts are a restraint of trade. The tendency of the law will be to not enforce such contracts in the absence of special circumstances: *J.G. Collins Insurance Agencies Ltd. v. Elsley* [1978] 2 S.C.R. 916.

A covenant extracted by a purchaser from a vendor on the sale of the goodwill of a business, however, stands on a different footing than the typical employment contract: *Burgess v. Industrial Frictions & Supply Co. Ltd.* (1987), 12 B.C.L.R. (2d) 85 (C.A.) at 95. The approach of the law is to consider such contracts reasonable and the restraint of trade a matter that is properly protected under the contract.

The degree of restrictions upon the departing vendor will largely depend on the contractual terms in question. Even in the absence, however, of express contractual terms in the contract of purchase concerning competition, a departing vendor may face other legal obligations which restrict his or her ability to compete with the purchaser of the business.

B. Competition in the Absence of a Restrictive Covenant

If the parties to an employment contract did not agree to a restrictive covenant, the courts will not imply one: *Read and Read v. Wright* (1963), 45 W.W.R. 108. There is too much ambiguity involved to imply such a term into an agreement.

Nevertheless, the principles in *Trego v. Hunt* [1896] A.C. 7 (H.L.), can be invoked to prevent the vendor from soliciting the very customers of the business which he has sold.

C. *Trego v. Hunt*

The House of Lords decision in *Trego v. Hunt* is the leading case concerning competition by a departing vendor.

Interestingly, *Trego v. Hunt* did not actually involve the purchase of a business. In *Trego v. Hunt*, Mr. Trego brought Mr. Hunt into a partnership in 1876, but with a contractual term that the goodwill of the business should be and remain the sole property of Mr. Trego. The partnership continued in this manner until Mr. Trego died in 1888. The following year, a partnership agreement was made between Mr. Trego's widow, Anna Trego, and one William Smith, with Mr. Hunt. That agreement provided that the goodwill would remain the sole property of Anna Trego. About five or six years later, it was discovered that Mr. Hunt had employed a clerk of the firm to copy for him, after office hours, the names and addresses of all the firm's customers. When confronted, Mr. Hunt admitted that he was having the list prepared so that when the partnership expired, he could go about canvassing these customers in order to endeavour to obtain their business for himself, in a rival business. Trego and Smith sought an injunction to restrain Mr. Hunt from continuing this practise.

The judgments of Lord McNaughton and Lord Hershell, each arrived at the same result under somewhat different reasoning. Perhaps the most oft quoted statement is that of Lord McNaughton, who said:

... a man may not derogate his own grant; the vendor is not at liberty to destroy or depreciate the thing he has sold; there is an implied covenant, on the sale of the goodwill, that the vendor does not solicit the custom which he has parted with: It would be a fraud on the contract to do so.

Lord Hershell said:

It is not material to consider whether, on the sale of a goodwill, the obligation on the part of the vendor to refrain from canvassing the customers is to be regarded as based on the principle that he is not entitled to depreciate that which he has sold, or as arising from an implied contract to abstain from any act intended to deprive the purchaser of that which has been sold to him and restore it to the vendor. I am satisfied that the obligation exists, and it ought to be enforced by a court of equity.

D. Application of the Principles in *Trego v. Hunt*

Trego v. Hunt has been considered in Canada, and other common law jurisdictions, many times. More recently, Mr. Justice Paris in *Unisource Canada Inc. v. Enterprise Paper Co.*, [1999] B.C.J. No. 753, reviewed some of the Canadian, American and Australian cases that have followed *Trego v. Hunt*.

Some American authorities have arguably expanded the “*Trego* principle”. For example, in *Mohawk Maintenance Co. Inc. v. Kessler*, 419 N.E. 2d 324 (Court of Appeals of New York, 1981), the court said the following:

More importantly, the right acquired by the purchaser of the “goodwill” of a business by virtue of this “implied covenant” must logically be regarded as a permanent one that is not subject to divestiture upon the passage of a reasonable period of time. Indeed, it may be somewhat misleading to describe the duty of the seller to refrain from soliciting his former customers as one emanating from an “implied covenant”, since the duty is, in reality, one imposed by law in order to prevent the seller from taking back that which he has purported to sell.

The Supreme Court of New York, Appellate Division, in *Kraft Agency, Inc. v. Delmonico*, 494 N.Y.S. 2d 77 (1985), said that the *Trego* principle is not subject to a test of reasonableness and is of indefinite duration. The court also said that “irrespective of any term in the contract”, the seller is prevented from depreciating the value of the goodwill by soliciting former customers. This suggests that a party may not even be able to covenant out of the *Trego* principle.

Mr. Justice Paris, in *Unisource Canada Inc.*, refused to apply such a broad interpretation of the *Trego* principle.

Part of the difficulty that may stem from *Trego v. Hunt* turns on whether or not the *Trego* principle is considered an implied covenant in the contract, or a principle that is enforced by a court of equity.

If the *Trego* principle is considered to be an implied term of the contract, then it may be subject to other express contractual terms. On the other hand, if the *Trego* principle is viewed as a principle of equity, then it may be argued that the vendor cannot contract out of it (at least not without clear and unambiguous language). It is also an open question whether today the *Trego* principle would simply fall within the law of fiduciary obligations.

For example, in *Western United Insurance Brokers Ltd. v. MacDonald*, [1994] B.C.J. No. 780, Madam Justice Saunders (as she then was) noted that the defendant was both in breach of the *Trego* principle and his fiduciary obligations owed to the plaintiff.

In that case, Mr. MacDonald sold his insurance agency business to Western United Insurance Brokers. At the time of the sale, he signed a non-competition agreement which provided that he would not compete with the plaintiff for three years within a 50 mile radius of the business. Mr. MacDonald waited three years and then started working for another insurance agency.

The Court found that by reason of the *Trego* principle, Mr. MacDonald was prohibited from soliciting former customers of his insurance agency, indefinitely, notwithstanding that the three year restrictive covenant had expired. The Court further found that Mr. MacDonald owed, and breached, a fiduciary duty he owed to the plaintiff, by soliciting the customers of his former business.

As noted, the law of fiduciary obligations also provides a purchaser with a remedy to attempt to restrict competition from a departing vendor.

E. Fiduciary Obligations

There is no doubt that certain top level employees or senior management employees may be found to owe fiduciary obligations that restrict their ability to compete with their former employer: *Alberts et. al. v. Mountjoy* (1977) 79 D.L.R. (3d) 108. In the case of the departing vendor, the fiduciary obligations may be more onerous.

In *Burgess v. Industrial Frictions & Supply Co. Ltd.* supra, Mr. Burgess had been the major shareholder, director and officer of the Industrial Frictions and Supply Company. He decided to retire and sold his shares in the business. The sale agreement provided that he would be paid in installments. The contract provided that he would continuously conduct himself as a fiduciary to the company. Another clause of the contract provided that for the next five years, he would not be engaged in any business carried on by the company.

Six years after his retirement, he commenced working for a competitor business. As such, the specific clause in the contract that dealt with him not competing, no longer applied. Nevertheless, the company ceased making payments to Mr. Burgess, alleging that he had breached his fiduciary obligations to the company. Mr. Burgess sued for the outstanding installments. Madam Justice McLachlin, as she then was, speaking for the majority of the British Columbia Court of Appeal, agreed with the company that Mr. Burgess had breached his covenant to continue to act as a fiduciary to the company. The court said:

Burgess' present employment requires him to deal and communicate with clients of Industrial's only major competitor. This involves dealing with some of the old customers of Industrial. In these circumstances, given the limited nature of the clientele and the slow rate of change in the business in question, Burgess' work must necessarily involve conflict between his duty to Industrial and his duty to his new employer. It follows that Burgess is failing to conduct himself as a fiduciary of Industrial.

It must be borne in mind, however, that in *Burgess* there was an express contractual provision that required Mr. Burgess to conduct himself as a fiduciary towards his former business.

Another decision of the British Columbia Court of Appeal found a departing vendor in breach of a fiduciary agreement, without application of the *Trego* principle and without a restrictive covenant. *Roe, McNeill & Co. v. McNeill*, [1998] B.C.J. No. 327, involved a chartered accountant practice. For approximately 13 years, Mr. McNeill had operated a general accounting practice in West Vancouver. He decided to sell the practice to Douglas and Robert Roe. In 1988, they agreed to purchase the practice and they agreed that Mr. McNeill, through his management company, would provide chartered accounting and consulting services to the new business, Roe, McNeill & Co., over a period of three years.

The first two years ran fairly smoothly. In the third year, Mr. McNeill had moved to Gabriola Island. He began servicing Roe, McNeill & Co. clients from Gabriola Island, in competition with the Roe brothers. The Court of Appeal said:

... It cannot be disputed, that under the terms of this contract, Roe, McNeill “did indeed find itself in a most vulnerable situation”. Applying the other criteria from *Frame v. Smith* I think there can also be no doubt that under the contract McNeill was in a position to exercise a discretion or power which he could exercise unilaterally to affect Roe, McNeill’s practical interest. McNeill had a close relationship with his former clients, and was in a powerful position to influence the transfer of their business to Roe, McNeill. That is what he agreed to do. That he could, unilaterally, affect Roe, McNeill’s interest by the way in which he exercised that power is self-evident. The Roe brothers were in a position of having to trust McNeill to effect his end of the bargain, and were at McNeill’s mercy if the latter failed to do so.

Further on the court stated:

Looking at the agreement as a whole, and at the obligations and burdens which both parties agreed to accept, it seems to me that McNeill’s position during the pendency of the contract was an analogous to that of a “key employee”. He was required to work in Roe, McNeill’s best interests, and there were remuneration incentives, both positive and negative. And he did agree to the terms of the covenant, restricting his right to compete with Roe, McNeill in areas from which his former clientele was drawn. I do not see anything in that, however, which is inconsistent with, or which should prevent, the imposition of a fiduciary duty.

...

In my view, the agreement entered into by the parties gave rise to mutual reasonable expectations that McNeill would act for Roe, McNeill’s benefit and that he would not abuse the position of power he held as a result of the agreement entered into. I think McNeill was subject to a fiduciary duty, independent of the contract, and must be found in breach of it, for the same reasons he was found in breach of the contract.

Similar findings have been made by courts in Ontario, applying *Trego v. Hunt* and the law of fiduciary duties. See, for example, *John Labatt Limited v. Green* (1989), 27 C.P.R. (3d) 404 and *Commercial Transport Ltd. v. Watkins* (1983), 22 B.L.R. 249.

II. Conclusion

Our courts may not go as far as some American courts have in applying the *Trego* principle. Nevertheless, it would seem that clear and unambiguous language in the contract would be required to avoid its effect or to enable a vendor to avoid his or her fiduciary obligations. Restrictive covenants in typical employment contracts will usually have geographic, as well as

temporal limitations. The *Trego* principle, and arguably the fiduciary obligations that a departing vendor may owe to the purchaser, however, may have no temporal or geographic limitations. On the other hand, the *Trego* principle, and the law of fiduciary obligations, will not prevent a departing vendor from altogether competing with the purchaser of a business, such as a restrictive covenant may. These obligations, when applicable, would only prevent the departing vendor from soliciting the very same customers or depreciating the goodwill that has been sold.