

UPON REFLECTION - WHAT IS THE IMPACT OF STAEBLER?*

By Steven Borlak

**This is the original form of the article submitted to Canadian Insurance magazine. The published form was altered without Steve Borlak's knowledge or consent.*

I am admittedly preoccupied with the *Staebler* appeal decision.

Here is a quick (albeit over-simplified) reminder of the facts - The case involved 2 producers who left *Staebler* in 2003 and joined *Stevenson and Hunt*. The producers had both signed agreements with *Staebler* that confirmed *Staebler's* ownership of the business and imposed restrictions following termination of employment. Following their resignation, *Staebler* experienced the migration of many customers, and an injunction was obtained. The restrictions

signed by both producers prohibited them, for a period of two years, from “conducting business” with any clients that were handled or serviced by them at the date of disengagement.

The Trial Judge awarded damages based on a breach of the restrictive covenants. The Ontario Court of Appeal reversed the decision. Specifically, the Court concluded that the covenant signed by each producer was unenforceable, because it was in the nature of a non-competition covenant and was therefore unreasonably prohibitive.

Remember *Scarlett O'Hara's* house servant *Mammy* in *Gone with the Wind*? After *Scarlett* committed her latest in a series of moral missteps, I believe that *Mammy's* reaction was - “*It ain't right Miss Scarlett. It ain't right, it ain't right, it just ain't right.*” Honestly, this was my first reaction after reading the Court of Appeal decision.

I have reviewed the decision over and over. With the benefit of time for reflection, my reaction is tempered and I will elaborate below. First, I will try to put the matter into context.

CONTEXT

Restrictive Covenants and the Law

Although the law of contract is based on the notion of freedom of contract, the common law system has always frowned upon contracts that are in restraint of trade. It does not matter that the parties voluntarily agreed to matters in restraint of trade. If such covenants are judicially tested and determined to be unreasonably prohibitive, they are voided by the Courts because they are not in the public interest and are therefore unenforceable.

As cited in the *Staebler* Court of Appeal decision, Courts appear to have accepted that an appropriately limited non-solicitation clause generally offers sufficient protection for an employer. A non-competition clause, on the other hand, will only be enforced in

exceptional circumstances involving workers. Also, “the fact that a clause might have been enforceable had it been drafted in narrower terms will not save it. The question is not whether a valid agreement might have been made but whether the agreement that was made is valid”. In other words, Courts are usually unwilling to ‘read down’ or sever an offensive restriction in order to make the remaining covenant acceptable.

Courts have always tested workers’ restrictive covenants more stringently than the covenants that are given by a vendor to a purchaser. Two reasons are commonly cited. First, the Courts have judicially recognized that workers generally have less bargaining power than most employers. Secondly, as a practical matter, Courts have recognized that they must permit greater latitude to restrictive covenants in a situation involving sales. If such latitude is not provided for sale transactions, and if a vendor is therefore free to compete following the completion of a transaction, a purchaser would never purchase such a business. Thus the Courts would be defeating commerce.

I should also emphasize that it is important for any agreement to be signed before a worker commences the term of the engagement. If a broker fails to do so, the law of contract creates another hurdle. Restrictive covenants that are not contained in the original contract and that are imposed by the broker following the inception of the working relationship are not supported by consideration and may be unenforceable for this reason alone.

BROKER JOE

So consider the following example. Broker Joe hires a producer. At the time of hire, Broker Joe has a plan. The plan includes an investment in the producer. The revenue generated by the producer, particularly if the producer is new in the industry, will not be enough for many years to justify the compensation paid to the producer, let alone the direct expenses associated with the producer, and a reasonable allocation of Broker Joe’s overhead expenses. Broker Joe may never see a reasonable return on the investment unless he can enjoy the

benefit of ownership of the business that is produced, developed, handled or serviced by the producer. Put simply, Broker Joe’s hiring decision is predicated upon his ability to stake a claim on ownership of the ‘producer’s book of business’ and, even more importantly, his ability to protect such ownership from attack by the producer following disengagement. This is the basis of the deal *that is understood by Broker Joe and the producer when the producer is hired.*

In order to meet Broker Joe’s legitimate expectations, he should insist upon the execution of an agreement by the producer that contains provisions establishing ownership, and that restricts activities of the producer both during the term of the relationship and following the disengagement of the parties.

Certainly, there are other circumstances where a broker may not require the protection of restrictive covenants. For example, a producer may walk in with a book of business and insist upon retaining ownership. In such cases, the broker should not seek the same protection of restrictive covenants (producer may seek protection from broker). Again, it is important that *both parties understand their respective rights from the outset.*

By the way, there are also plenty of examples where a broker in Broker Joe’s situation fails to insist upon the execution of any documentation. In those cases, the broker is left to the whims of common law (or Quebec Civil Code) for any protection. There are some recent cases in this area that are extremely troubling. For a better understanding of this predicament, I ask you to wait for a future article. In the meantime, good luck, you’ll need it!

Let’s get back to Broker Joe. His producer departs and there is a noticeable migration of customers to the producer’s new broker. Broker Joe wishes to prevent any further migration of customers. Where does that leave Broker Joe? Consider the 2 following possibilities:

1. To be on the ‘safe side’, Broker Joe imposed a conventional non-solicitation covenant. He did so in order to be aligned with the reasoning in most of the decided cases, i.e. that a conventional non-solicitation covenant is adequate to protect the proprietary interests of Broker Joe. This means that Broker Joe will now have to establish that his former producer has solicited customers. What is the producer’s likely response? “I did not solicit the customers. The customers solicited me.” If the Court is satisfied by evidence that this is the case, the former producer will not be in violation of the covenant, and Broker Joe will be legally unable to prevent the producer from accepting the business from the customers.
2. Broker Joe recognized the obvious gap in the conventional non-solicitation covenant so he elected to be more aggressive with the original restrictions. He imposed a ‘hybrid covenant’ on the producer that prohibits the producer from (a) soliciting business from customers (as in #1 above), and (b) accepting business from such customers (whether or not the business was solicited by the producer). It is this hybrid covenant that might be more vulnerable as a result of *Staebler*, depending on its qualities, and the surrounding facts.

IMPACT OF STAEBLER

Getting back to *Staebler*, what is the impact of the recent appeal decision?

My preferred view is that this was simply another restrictive covenant case that should be analyzed and respected based on its specific facts. Courts will not enforce restrictive covenants unless the broker is able to demonstrate that the covenants are fair and reasonably required to protect proprietary rights. The *Staebler* covenant prohibited the producers from ‘conducting business’ with the customers. This was found to be too broad. In theory, this covenant would have prevented the producers from selling widgets to the customers. Although it is reasonable to assume that the parties

probably intended for this to only prevent the producers from conducting P&C business with the customers, this limitation was not expressed.

Another view is that Courts will not accept anything beyond a mere non-solicitation covenant except in vendor or ‘vendor-like’ circumstances and that the window for hybrid clauses in worker relationships may be virtually shut.

Where does this leave us?

1. At the time of hire, brokers should consider their strategies in hiring producers and they should assess their model in view of the limitations on the ability to legally protect proprietary rights. Purchasers should also evaluate the existing covenants of a target brokerage to assess the degree of legal protection for the acquired portfolio. Perhaps at some point, if uncertainty impacts the level of hiring or the level of commerce, Courts will take judicial recognition and alter their tolerance of restrictive covenants for workers.
2. Take care when using restrictive covenants. Brokers are faced with difficult choices. The conventional non-solicitation is more likely to be enforced but may be inadequate. The ‘hybrid clause’ is more suitable but is not necessarily enforceable. Both covenants can be included in an agreement but there are also some concerns in that area because of the unwillingness of Courts to ‘sever’.
3. Make sure that the documentation reflects as much narrowing as possible if this will be sufficient. For instance, is the worker involved with all customers in the brokerage or just customers that the producer has produced, serviced or handled? Is the worker only involved in a narrow product line and not the entire spectrum of products at the brokerage?

4. In *Staebler*, the Court of Appeal pointed out that other producers in the office were bound by different weaker restrictions and concluded that the weaker restrictions in the other agreements therefore ought to have been adequate. Brokers should take heed of this and try to develop uniformity with the restrictions in their producer agreements. Alternatively, if there are different formats, brokers should be ready with an explanation for the differences.
5. You should have the documentation in your office reviewed by a lawyer. In doing so, I remind you that there is a legal impediment associated with re-writing an agreement following the inception of the working relationship.

After an opportunity to reflect, I think that the *Staebler* case is just another restrictive covenant decision based on its facts. Nevertheless, it should at least serve as a wake-up. Brokers should take time to carefully evaluate their existing documentation in order to assess and be proactive in the protection of their ownership rights.

Follow up clarification regarding November 2008 Canadian Insurance article:

I am writing about an article that appeared in the November 2008 CI magazine under 'Brokers and the Law' (page 34). The article was written by me and involved an analysis of the *Staebler* Ontario Court of Appeal decision. Without my knowledge (through oversight), the final published form differed from my written submitted version. I am concerned that the edited version may lead the reader to certain inaccurate conclusions.

- In its amended form, readers may conclude that I am in agreement with the Ontario Court of Appeal decision. This is absolutely not true. While I am ambivalent regarding the specific result for the litigants, I am disappointed with and disturbed by the reasoning of the Court of Appeal. The Court had the opportunity to provide real guidance regarding the

use of 'hybrid' restrictive covenants. Instead, the Court shunned general policy and responded tersely to the facts. As a result, any conclusions from the decision are speculative. In particular, we are left wondering about the availability (enforceability) of 'hybrid' restrictive covenants.

- The published version included the following subtitle - 'Revisiting the *Staebler* decision: are non-compete clauses too prohibitive?' This was a very unfortunate [careless] use of terminology. As indicated in the Article, 'non-competition' clauses for workers will only be accepted and enforced by Courts in exceptional circumstances. This is a clear and supportable position that has been respected for decades. On the other end of the spectrum, Courts are generally willing to enforce non-solicitation clauses against workers. The unanswered question is whether 'exceptional circumstances' must exist before Courts will ever enforce suitably drafted 'hybrid' clauses against workers. I have consistently preached that such 'hybrid' protection is necessary to genuinely protect a broker's proprietary rights as against its former workers, because a mere non-solicitation covenant leaves a huge unprotected gap. 'Hybrid' clauses are designed to prevent workers from accepting competing business from a defined class of the broker's customers (whether or not the former worker has solicited such business).