Restrictive Covenants in the Sale of a Business

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I. **Historical Background**

For over five hundred years the common law courts have dealt with cases involving contractual restrictions on the ability of a party to carry on a business or trade. Although the vast majority of early cases dealt with covenants ancillary to contracts of employment the principles applied were extended to covenants ancillary to the sale of a business.

In essence, the problem which arose in these cases was always a conflict between two freedoms; the freedom to contract, and the freedom to trade as one wishes. However, the ways in which courts have approached and resolved this conflict have varied greatly over the years.

Cheshire and Fifoot suggest that the principal reason why judicial views of restraint of trade covenants have changed over the years is that public policy changes over time. They state "the doctrine of restraint of trade is based upon public policy, and its application has been peculiarly influenced by changing views of what is desirable in the public interest." For instance, they report that originally all restraints of trade were considered to be invalid. In Elizabethan days it was believed that such covenants tended to create monopolies and therefore were struck down.

The principal reason why courts at this time wanted to prevent monopolies was that they believed that such organizations tended to increase prices, reduce quality and increase unemployment. This view of monopolies flowed from the type of monopolies which the Crown at that time was granting. According to Collinge, Elizabethan courts believed that they had a responsibility to prevent such monopolies and to preserve conditions in which free competition would thrive.

A further reason why all restraints of trade were invalid at that time is advanced by Letwin. He suggests that courts were attempting to curtail the power of the guilds. In the fifteenth and sixteenth centuries movement of
tradesmen from one town to another was nearly impossible because guilds and municipal corporations had by-laws which prevented outsiders from entering into competition with citizens. Thus, if a tradesman was not able to work in his home town, because of a restrictive covenant, he would not be able to practice his trade. Letwin writes:

"The whole guild system, therefore, made it nearly impossible for a tradesman to earn his living if he did not practice his own trade in his own town, and this was the main reason why, as long as the guilds maintained their power, contracts in restraint of trade were held void."6

However, when the power of the guilds and their ability to prevent movement between towns began to erode, courts began to take a different view of restraints. The first movement away from the strict prohibition of restraint of trade clauses came in 1614 with the decision of Rogers v. Parrey.7 There the defendant leased a shop from the plaintiff for a period of twenty one years. In the lease agreement the defendant had covenanted that he would not practise his trade as a joiner in that shop. The court held this clause to be valid because it was only a partial restraint and not a general one. The distinction between the two was defined in a later case: "A general restraint is an employment restriction which extends throughout the kingdom or, perhaps, indefinitely in time. A particular (or partial) restraint is more limited in an area or applied only to certain persons, presumably clientele of the business involved".8 The distinction reflected the fact that there was a growing appreciation that purchasers of a business required some measures to protect their investment, but it would be oppressive to extend this protection so as to include a general restraint.

Although Rogers v. Parrey initiated the distinction between partial and general restraints this test did not become fully developed until Mitchell v. Reynolds9 was decided in 1711. Heydon10 suggests that the main value of this case lies in its review of trade restraints. Summarizing the result of cases
to that point in time, Parker, C.J. (later Lord Macclesfield) stated:

"General restraints are all void, whether by bond, covenant or promise, with or without consideration and whether it be of the party's own trade or not.... Particular restraints ... without consideration are all void by whatever sort of contract created .... Where a contract for restraint of trade appears to be made upon a good and adequate consideration, so as to make it a proper and useful contract, it is good."\(^{11}\)

The distinction between general and partial restraints seems to have been followed, for the most part, for over 150 years after Mitchell v. Reynolds until the end of the nineteenth century. Courts would hold all general restraints to be invalid, but partial restraints were valid and enforceable if they were reasonable. There were exceptions, however, where general restraints were not automatically declared invalid.\(^{12}\) Perhaps the major reason why this departure from the rule took place is that some courts began to recognize that a general restraint might be necessary to protect the purchaser's interest. In 1711 when the rule was formulated, Lord Macclesfield had asked, "what does it signify to a tradesman in London what another does in Newcastle?" However, with improvements in transportation and communications, potential market areas grew and businesses became increasingly affected by the activities of competitors in other parts of the country.

Even though the general/partial distinction was under attack for a number of years, it was not until Nordenfelt v. Maxim Nordenfelt Guns and Ammunition Co. Ltd.\(^{13}\) was decided in 1894 that it was finally put to rest. There it was held that a general restraint was valid because it was necessary to give proper protection to the purchaser of an ammunition firm since the market for armaments was essentially world-wide. Without such a clause the seller (Nordenfelt) could significantly reduce the value of the goodwill of the business if he decided to compete with the purchaser. In addition to holding that this restraint was valid the court also laid down a rule as to how restraints should be viewed in the future. Lord Macnaghten stated:
"All interferences with individual liberty of action in trading, and all restraints of trade of themselves, if there is nothing more, are contrary to the public policy and therefore void. That is the general rule. But there are exceptions: restraints of trade ... may be justified by the special circumstances of a particular case. It is a sufficient justification, and indeed it is the only justification, if the restriction is reasonable - reasonable, that is, in reference to the interest of the parties concerned and reasonable in reference to the interests of the public, so framed and guarded as to afford adequate protection to the party in whose favour it is imposed, while at the same time it is in no way injurious to the public."\(^{14}\)

Thus, the test which developed from Nordenfelt, and which is still essentially the common law test today is whether or not the restraint is reasonable. To be valid, a clause must be reasonable as between the parties to the sale of the business, as well as being reasonable vis-à-vis the public. Should it fail to be reasonable on either of these tests it will be struck down by the court.

II. Current State of the Doctrine

(1) Introduction

As we have seen in the previous section, courts have for a long time accepted the viewpoint that not all covenants which restrict trade are necessarily invalid. With respect to covenants ancillary to the sale of a business, courts have appreciated that some restrictions may be needed if the purchaser is to protect his investment in the goodwill of the business. As stated by Lord Macmillan in Vancouver Breweries Ltd. v. Vancouver Malt & Sake Brewing Co. Ltd.:\(^{15}\)

"The law does not condemn every covenant which is in restraint of trade, for it recognizes that in certain cases it may be legitimate and indeed beneficial that a person should limit his future commercial activities as, for example, where he would be unable to obtain a good price on the sale of his business unless he came under an obligation not to compete with the purchaser."
Corbin explains the role of a covenant in restraint of trade in the sale of a business as follows:  

"When one buys the business of another as a going concern, he usually wishes to keep it going; he wishes to get the location, the building, the stock in trade, and the customers. He wishes to step into the seller's shoes and to enjoy the same business relations with other men. He is willing to pay much more if he can get the "good will" of the business, meaning by this the good will of the customers, that they may continue to tread the old footpath to his door and maintain with him the business relations enjoyed by the seller.

Although these business relations and friendly feelings are not possible of transfer by assignment, experience has long since proved that the seller can do much to enable the buyer to enjoy them in his place. He does this by selling the business with its "good will." The buyer occupies the same store, handles the same merchandise, and advertises that he is "successor." The customers come to his store according to old habit; and the buyer has a going concern from the beginning. In order to be well assured of this, he obtains and pays for the seller's promise not to reopen business in competition with the business sold. It is this promise of the seller that is in restraint of trade and commerce."

What this section will attempt to do is identify those factors which may lead a court to hold that a restraint is legitimate, or conversely, what factors may cause a court to strike down a covenant. Following the test enunciated in Nordenfelt we will see firstly how the courts have viewed 'reasonableness in reference to the interest of the parties concerned' and secondly how they have viewed 'reasonableness in reference to the interests of the public.' Each of these tests have given rise to different concerns, so for the purpose of this section they will be examined separately.

(ii) Interest of the parties concerned

Following Mr. Justice Dickson in Elsley v. J.G. Collins Insurance Agencies Ltd. a case concerned with a covenant in an employment contract we will analyze the cases by asking two questions. Firstly, was there a proprietary interest which was entitled to protection? Secondly, were the temporal or spatial
features of the clause which gave the protection too broad? It is only if both these questions can be answered in favour of the purchaser that the clause will be held to be reasonable as between the parties.

(a) **Proprietary Interest**

So long as there has actually been a sale of a business one might think that there is a proprietary interest entitled to protection. However, this will not always be the case. Since restrictive covenants are designed to protect the goodwill of a business, a court will want to be assured that in fact there has been a sale of goodwill and not just the assets. Such an examination was undertaken in the case of *Wong v. Cook.* 19 There the British Columbia Supreme Court determined that the parties agreed that part of the purchase price was for goodwill and not physical assets. Therefore they held that there was an interest that needed protection. 20

It would seem however, that the correct question is 'Has a business been sold as a going concern?' If the answer is yes, then *prima facie* there is goodwill which justifies protection by means of a restrictive covenant. Whether or not the parties allocate a specific part of the purchase price to goodwill would seem to be irrelevant.

Without the sale of a business, or other arrangement, however a restrictive covenant is void. The Privy Council in *Vancouver Malt & Sake Brewing v. Vancouver Breweries,* stated:

"The covenants restrictive of competition which have been sustained have all been ancillary to some main transaction, contract or arrangement, and have been found justified because they were reasonably necessary to render that transaction, contract or arrangement effective." 21

In *McAllister v. Cardinal* 22 Stewart J. said that for a covenant to be valid it must, among other things, be for the business acquired. The restrictive covenant can apply only to the goodwill of the business acquired in the transaction, and not to the goodwill of any other business which the purchaser may own or
subsequently purchase. In support of this position Stewart J. stated:

"...the restraint must be for the protection of the business sold and in which the covenantee has an interest but is not to be judged the extent and circumstances of any other business of which, after transfer, the business sold becomes a part."\textsuperscript{23}

An approach similar to the above has been followed in the United States. For instance, in \textit{Seline v. Baker}\textsuperscript{24} the covenant required the defendant (vendor) to refrain from competing, in any manner, with the purchaser for a period of three years in any area within a 300 mile radius of Houston, Texas. The court refused to allow enforcement of this covenant partly because, in its words:

"An agreement not to compete with the corporation in any business which a corporation might desire to enter would clearly be unreasonable since the plaintiff could never know with certainty what type of business activity she might properly enter."\textsuperscript{25}

Thus, as in Canada, it appears that American courts will only give approval to those covenants which relate directly to the goodwill sold, and not the goodwill of any other type of business. As Corbin puts it, "legality depends upon the extent of the business sold, not upon the extent of the buyer's business."\textsuperscript{26}

(b) \textbf{Is the clause too broad?}

The courts must inquire as to whether the terms of the restriction are so broad as to make it unreasonable. That is, a covenant will be struck down if the court believes that the geographic area in which the restriction is effective or the time over which it applies is wider than necessary.

Perhaps the main principle which guides a court in deciding whether a covenant is too wide in area is that outlined by \textit{Lord} Parker in \textit{Morris (Herbert) Ltd. v. Saxelby}.\textsuperscript{27} There, he stated that:

"The covenant against competition is, therefore, reasonable if confined to the area within which it would in all probability enure to the injury of the purchaser."\textsuperscript{28}

This principle has been frequently applied.\textsuperscript{29}

In determining whether injury will occur to the purchaser if competition is permitted, courts appear willing to consider several factors. First, of course,
is the extent of the business carried on by the vendor. As with the issue of whether or not there is an interest to be protected, courts, in most cases, seem prepared only to protect the goodwill which was actually purchased and only to the extent that business was carried on at the time of the sale. In Huberman v. Hadath, MacFarlane J. held that the plaintiff (purchaser) could not prevent the defendant (vendor) from operating a reducing salon in Kamloops, B.C. despite the fact that the covenant was quite clear that such activity was prohibited. His reason for so holding was that at the time of sale the business sold only operated in the Vancouver area and so a salon in Kamloops could not cause injury to this business. The fact that the plaintiff was no longer able to sell a franchise in the Kamloops area, as she had planned to do, was held to be irrelevant. Similar reasoning had been used in cases such as McAllister, or the U.S. case of Schultz v. Johnson where protection was limited to the area in which the business which was sold was carried on.

Although covenants which cover an area much larger than the business area at the time of sale will be considered unreasonable the case law indicates that courts will consider a larger area if expansion of the business acquired was factor contemplated by the parties when the sale was made. For example, in McAllister Stewart J. refused to regard the future potentiality for development as an important factor but he did state that "no doubt to some degree prospects of expansion at the time of sale should be considered." In Huberman, even though he found for the defendant (vendor), MacFarlane J. did consider whether or not expansion had been contemplated by the parties. Thus, there is support for the proposition that a restriction may be reasonable even if it extends beyond the area of business at the time of sale.

The goodwill of a company may extend throughout an area notwithstanding that business is not carried out in each community within that area. In Connors, Viscount Maugham stated:
"It should also be observed that the question of reasonableness being a matter of law for the Court, it has never yet been supposed that it is necessary in relation to the trade of a large manufacturer or merchant to prove to the satisfaction of the Court that the business which the covenant is designed to protect has been carried on in every part of the area mentioned in the covenant. In the cases in which the area has been the whole of England, or a substantial part of it such as 100 or 150 miles from a named town, it has never been held that the covenantee was under an obligation to prove that the business has been carried on in all the towns and villages within the area."

Courts will also consider the nature of the business. As an example of such an examination Locke J. in Wong v. Cook gave a relatively detailed explanation of the characteristics of the parcel pick-up and delivery business in British Columbia. He found that the business is "volatile in nature, and appears to depend much upon the personality and reliability of the driver of the vehicle who calls at the customer's premises, receives a bill of lading and delivers it to its appropriate destination. Personal loyalty to the driver plays a great part in building up business and customers can and do switch their business quite rapidly." Because of the importance of personality, and the fact that Cook (the vendor) was a 'devastatingly effective salesman,' Mr. Justice Locke held that the covenant preventing Cooke from competing in the lower mainland of British Columbia was reasonable. Without such a covenant Wong's business would suffer greatly, as in fact it did when Cook went into competition and lured away many of Wong's customers.

In Re Giannone and Stampeders Motor Hotel Ltd. Kirby J. also undertook a form of market analysis. In that case the plaintiffs (vendor) successfully prevented the enforcement of a restrictive covenant against them by the defendants (purchaser). The exact wording of the covenant was as follows:

"12. In consideration of the Purchaser entering into this agreement each of the Shareholders hereby covenants that he or she will not, for a period of 15 years...either directly or indirectly undertake or carry on, or be engaged or concerned, or interested, either alone or in partnership with, or as manager, agent or
servant, or any other person, firm or company, or as shareholder or director of a limited company or otherwise, in the business of a hotel, motel or motor hotel or any similar business within the City of Calgary or within 15 miles of the boundaries of the City of Calgary.

The plaintiffs sought to have this covenant declared unreasonable as they now wished to become involved in another hotel which was to be constructed 1 1/2 miles away from the Stamped Motor Hotel (the business sold).

In giving judgment Mr. Justice Kirby held that there would not necessarily be a decrease in business to the Stamped Motor Hotel if the new hotel was constructed because the two hotels would be drawing clients from different parts of the city. One would be situated in the retail and commercial area and the other in a more industrial neighbourhood. Also he believed that business would not be affected since the new hotel would be replacing a beverage room which was already competing with the Stamped Motor Hotel. Additionally, reliance was placed on the fact that the vendors were not trying to exploit any special name in violation of the covenant, nor were there any special factors they could use to draw customers away from the Stamped Motor Hotel since none of the applicants had ever come into contact with the clientele. Because of all these factors, Mr. Justice Kirby said that no injury would occur to the purchasers from the increased competition so that the restrictive covenant was unreasonable and therefore unenforceable.

Reasonableness vis a vis the parties relates to more than just the area of the covenant. Time is also a consideration. In theory, covenants should not extend forward in time beyond a point when there will be no injury to the purchaser if competition were to be allowed. The difficulty, of course, lies in defining when this point in time arises.

In commenting on the appropriateness of a specific time limit in Bliss and Laughlin Industries Inc. v. Doerner, Morden J.A. stated:
"Generally, the chief reason why a time restriction may be held to be unreasonably long is that it extends into a period where it may reasonably by thought that the purchaser would be on its own feet in the business and the influence of the seller diminished by his lack of contact with the trade."41

Despite the apparent logic of this statement, in most cases time limits will have little or no effect on the determination of reasonableness. Most courts appear to follow the position of the Privy Council in Connors where it was said:

"if the restriction as to space is considered to be reasonable it is seldom in a case where the sale of a goodwill is concerned that the restriction can be held to be unreasonable because there is no limit as to time."42

Such a view also widely prevails in the United States.43

This review of the cases shows that the courts take an active, involved role in dealing with this branch of the test. The courts will consider, inter alia the nature of the business in question, the geographical scope of the market and the true nature of the sale transaction in assessing the reasonableness as between the parties.

(ii) Interest of the public

The second limb of the Nordenfelt test requires that covenants in restraint of trade must be reasonable in reference to the interests of the public. Conceivably, a covenant could be reasonable as between the parties but be struck down as injurious to the public. In this section we will attempt to interpret what courts mean when they refer to 'the interest of the public' and identify how courts decide when a covenant is contrary to this interest.

Over the years there have been several different definitions offered of what constitutes the public interest. In both Nordenfelt44 (in the Court of Appeal) and in A.G. Australia v. Adelaide S.S. Co.45 the courts held that in the context of restraint of trade cases, a covenant was injurious to the public...
if it was calculated to produce a 'pernicious monopoly', i.e. a monopoly which was created to enhance prices to an unreasonable extent. On the other hand, in *Wong v. Cook*, 46 and *Elsley*, 47 the courts stated that the covenant would be contrary to the public interest if the public has suffered through the loss of the services of the seller.

One point which has been stressed in several of the cases which were examined is that of onus of proof. Mr. Justice Dickson in *Elsley* stated:

"After the party relying on a restrictive covenant has established its reasonableness as between the parties, the onus of proving that it is contrary to the public interest lies on the party attacking it." 48

Not only will the onus of proof lie upon the complaining party, but this onus will also be hard to satisfy. Courts appear to feel uneasy about striking down a contract on grounds of public policy after they have held it to be reasonable with reference to the interests of the parties involved. Viscount Maugham in *Connors* held that:

"When the Court is satisfied that the restraint is reasonable as between the parties it must always be very difficult to prove in a case connected with goodwill that the public interest is affected." 49

As an examination of the cases will show, courts have indeed made it very difficult to satisfy this onus of proof.

Just as definitions of the public interest vary between cases so do the approaches that courts will use to determine if a covenant is contrary to such interest. In *Elsley* the court considered the nature of the general insurance business in the Niagara Falls area. It noted that there were twenty to twenty-two general agents in the district and concluded that the people in the area would not suffer from the loss of the services of one particular agent, Elsley. A similar analysis was undertaken by Mr. Justice Locke in *Wong v. Cook*. There the court determined that there were 50 or 60 trucking companies in the lower mainland, 40 of whom were combination pick-up and courier services, with about
a dozen of this latter group depending on bus traffic for a large part of their business, just as the company in question did. Thus, the court held the covenant to be reasonable *vis a vis* the public interest because there were sufficient competitors so that the public would not suffer from the loss of one company.

Although in neither of these cases is there any detailed economic analysis of the way the markets in question functioned, the court in each case implicitly adopted an economic framework of analysis. To be able to conclude that the public would not suffer from the loss of one business the court must have considered how many insurance agents were needed to service Niagara Falls or how many pick-up services were necessary in the lower mainland of British Columbia. The problem, of course, is that when the analysis is not explicit we really have no way of knowing what factors a court will consider in deciding whether service is "sufficient". For example, in *Sharwayne Holdings Ltd. v. Dale Mitchell Construction Ltd.* the Alberta Supreme Court decided that for the area in question there were more than adequate sources of manufactured windows without the vendor and that suitable competition existed at the time. However, no indication is given of what the court considered to be an adequate number of sources or what was meant by suitable competition.

The Ontario Court of Appeal in *Bliss* held that the covenant in question was not in fact designed to create a pernicious monopoly. Finding that the vendor controlled 98 per cent of the Canadian "metal chair control" market before the sale was made the court quoted the trial judge with approval, as follows:

"[The covenant] did not create a monopoly. Such monopoly existed, so accordingly the covenant was in no way injurious to the public..."51

This position was affirmed by the Supreme Court of Canada on appeal.52 McIntyre J. in giving judgment for the Court agreed that a covenant could not be said to create a monopoly if one already existed. He stated:
"The monopoly had been created by the appellants themselves and it rested largely upon their skill and industry in the pursuit of their business activities. They sold the product of their skill and industry and were paid for it. I cannot agree that they may now say that their creature is an evil thing contrary to public policy..."53

Furthermore, both courts considered and accepted the trial judge's finding that the purchaser was not trying to abuse the existing monopoly by engaging in anti-competitive pricing.54 In establishing the second part of the test then, the plaintiff may have to show that the parties to the contract were intending to create a monopoly whereby unreasonable prices could be charged to the public. Undoubtedly it will be hard for the complaining party to prove this.

In Connors 55 we see a further example of how courts have handled the issue of monopolies and the public interest. The Privy Council in this case refused to accept that the covenant in question was designed to create a monopoly. Rather they took the view that the purchasers wanted only to protect their interest in the goodwill of the business. Also, they held that no monopoly was in fact created since any other individual could set up a sardine business in Canada if they wanted to. It made no difference if others could not effectively compete with Connors Bros. Ltd., as this was probably due to the 'skill and enterprise and long experience' of that company. Similar reasoning was followed in Bliss where Morden J.A. stated:

"any argument to the effect that the covenant was to create a monopoly fails to recognize that its enforcement cannot prevent others from competing in the market."56

It appears that the courts, in implementing the second branch of the test, are implicitly assuming that markets are relatively competitive. Some economists view markets as being relatively uncompetitive. They recognize that in the long run new firms will enter to dissipate monopoly profits but view the long run as being a very long time. Neo-classical economists, on the other hand, tend to view most markets as being workably competitive and assume that monopolies will be short-lived
given relatively free entry. The exclusion of one competitor, even a large one with experience in the relevant market, does not pose a serious threat to the public, on this view. It is this latter view that appears to implicitly underly the thinking of the Anglo-Canadian courts. Alternatively of course, the courts may simply be anxious to avoid entering the debate at all, and therefore refuse to strike down a covenant using the second branch of the text.

Public policy has been used to void an agreement whereby a newspaper agreed not to comment on fraudulent land schemes.⁵⁷ Other cases have held that covenants restraining doctors from are void as being contrary to public policy. One such case is Sherk v. Horowitz.⁵⁸ Although this case deal with the dissolution of a partnership rather than a sale of a business it is still useful for its discussion of the public interest.

An obstetrician agreed not to compete in the city of St. Catharines for a period of five years after he left the partnership. In striking down the covenant Mr. Justice Donohue said it was contrary to public policy because there was currently a shortage of obstetricians in St. Catharines, based on an accepted ratio of one obstetrician for every 10,000 people. At that time St. Catharines was well below this accepted ratio. There were indications, however, that even if the current ratio was acceptable the covenant would still be held invalid. His lordship stated that choosing a physician or surgeon is not skin to commercial transaction and that the women of St. Catharines were entitled to the continuing care of Dr. Horowitz. Additionally the judge relied on the fact that the Ontario Medical Association had passed a resolution disapproving of such covenants in contracts between physicians. He held that a restrictive covenant between medical people tends to further limit the right of the public
to deal with a profession which has a strong monopoly position. Thus from this case it appears that courts may apply different considerations of what constitutes the public interest to medical services than they would apply to other forms of business enterprise.

In Canada and the U.S. then, courts are unwilling to strike down covenants in restraint of trade using the pernicious monopoly test. However, where covenants which are otherwise reasonable violate public policy considerations such as freedom of the press or access to medical care will be declared void.

American law is substantially the same as Anglo-Canadian law. Restrictive covenants are tested by their reasonableness as between the contracting parties and the reasonableness of their effect upon the general public. American courts have generally rejected the contention that a covenant in restraint of trade may harm the public by depriving the public of the skills of the covenantor.

Contrary to Sherk v. Horowitz, U.S. courts have often rejected the contention that covenants in restraint of trade entered into by doctors should be declared void. In Bauer v. Sawyer the court considered the effect of the removal of one doctor in a community of 90,000 which was being served by 70 doctors. After commenting that they were unable to judge whether or not this would cause sufficient injury to the public to justify striking the restrictive covenant, the court stated:

"In any case, there's no reason why Dr. Sawyer cannot serve the public interest equally well by practicing in another community".

In Randolf v. Graham the court stated that the public would not be injured "since every other physician or surgeon of equal competency is at liberty to practice the same profession within the same limited territory".
The difference between Sherk v. Horowitz and the U.S. decisions in what the U.S. decisions are looking at the local market for medical services over time and in the context of the state-wide market. The U.S. courts have realized that doctors can move to the local community and that the doctor who moves away will provide medical services elsewhere. The decision in Sherk v. Horowitz looks at the local market in isolation at one point in time.

U.S. courts have held that the stifling of competition can involve an injury to the public which will warrant the non-enforcement of a restrictive covenant. Generally, the mere removal of one competitor is not considered injurious to the public. However, if the restrictive clause is used to create a monopoly the courts will not enforce it. For example, in a few cases, the courts would not enforce restrictive covenants where the evidence apparently showed that they were being utilized not merely to protect the purchaser's investment but as part of a series of purchases designed to give the purchaser a monopoly. In Merchants Ice & Cold Storage Company v. Rohrman the court determined that the contract before it was only one of a series of contracts by which the purchaser was acquiring a monopoly of the ice market. The contract was held unenforceable both under a Kentucky statute and the Common Law. The court stated that it was true that all purchases that involved a restrictive covenant removed some competition and that this was probably in all cases, one of the reasons for the purchase. The court stated that some purchases might create a monopoly and yet not injure the public. The court cited Knight & Jilloon Company v. Millar (Ind.) 87 N.E. 823 which states:

"...it is not necessary that a pure monopoly is effected, or that the restraint be a complete one."

The court also stated: "But the mere fact that no effort was made to control or fix or raise the price has little to do with the question. It is the purpose to control the market and suppress competition that constitutes the essential vice in the contract".
American cases seem to interpret the interest of the public in much the same way as the Anglo-Canadian authorities. However, unlike the Anglo-Canadian jurisprudence there are American cases which have actually struck down restrictive covenants which were designed to create a monopoly.

III. An Economic Framework of Analysis

a) The Nature of "Goodwill"

The cases on restrictive covenants in the sale of a business involve the sale of goodwill. Goodwill in this context is that portion of the price of a going concern which does not reflect the replacement cost of the physical assets. Goodwill arises whenever a business is in a position to enjoy profits which are greater than the normal level of profits in the economy. Economists call these profits "excess profits", "monopoly profits" or "quasi-rents". It may well be that goodwill represents a prior investment and that the company is earning a normal rate of profit on its total investment.

Suppose that in a certain business most firms can make a profit which covers their costs and gives them an adequate rate of return. Suppose that one firm (Co. X) in the industry can earn, for whatever reason, an extra $10,000 per year. If Co. X is sold, its owners will demand a price equal to the replacement cost of the physical assets plus a further amount to reflect the $10,000 per year. This latter amount will simply equal the present value of $10,000 per year over the expected "life" of the business. This present value of the future stream of $10,000 returns should equal the market price of the goodwill of the business.

Goodwill can arise in a number of ways. First, the business may have a monopoly or dominant position in the market. Second, the business may have certain trade secrets which are not known to its competitors. Third, the business may have acquired a "brand name". Fourth, the firm may have an established clientele.
The third and fourth types of goodwill are closely related. This type of goodwill is the type which is generally the subject of restrictive covenant cases.

"Brand names" are a response to consumer uncertainty. Consumers may pay $1 for a widget. If they knew that a certain brand of widgets were dependable they would pay $1.50. If Brand X has, through advertising and years of dependable service, convinced the public that its widgets are dependable, it can charge $1.50 per widget and gain excess profits. Of course, these "excess" profits may simply represent a normal sale of return on the prior investment in advertising and servicing.

Here the business earns only a nominal rate of return and fares a horizontal demand curve.

In diagram 2 the firm is earning excess profits which are equal to the shaded rectangle. The discounted value of this rectangle and all future excess profits equals the goodwill.

Some would argue that the presence of goodwill indicates that the market in question is not functioning well. The argument is that by advertising etc. producers have created an artificial distinction between their goods or services and those of their competitors. This artificial distinction enables
the seller to earn excess profits. The argument continues by stating that firms will compete for these excess profits by making socially wasteful expenditures (such as advertising). In this way the excess profits may be dissipated in socially wasteful expenditures. On this view, allowing sales of goodwill is harmful. By making goodwill transferable, its value is increased. Increasing the value of goodwill will consequently increase the amount of social resources spent in generating it.

On a different view, goodwill helps markets to function efficiently. Consumers face uncertainty in selecting goods and services. Firms make expenditures in establishing brand names and communicating information which reduce consumer uncertainty. Therefore goodwill represents expenditures which increase consumer welfare. Making these rights transferable encourages firms to make these expenditures which reduce the information imperfections of markets and allows them to function more efficiently.

The courts have implicitly accepted the second view and allowed firms to sell their goodwill. Clearly, if a firm sells its goodwill it must give a covenant not to compete. Otherwise, many customers would continue to rely on the goods and services of the original owner and the purchasers of the goodwill would find its value substantially diminished.

b) Rationales for Non-Enforcement of Restrictive Covenants

(i) Introduction

The common law does not enforce all contracts for the sale of goodwill. Why are some contracts disallowed? There would seem to be
three possible reasons. First, the law could be protecting one party from the other (i.e. unconscionability). Second, the law could be protecting third parties (i.e. consumer protection). Third, the law could be protecting one party from himself (i.e. paternalism).

(ii) "unconscionability"

The common law rule regarding restrictive covenants, as mentioned above in Section 2, is that the covenant in restraint of trade must be (1) reasonable between the parties and (2) reasonable with reference to the public interest.

At first glance, the first branch of the rule would seem to be concerned with unconscionability. There is some judicial support for this view. In explaining why the courts would uphold restrictive covenants in the sale of a business more willingly than covenants in employment contracts, Dickson J. in Elesly state74:

"...A person seeking to sell his business might find himself with an unsaleable commodity if denied the right to assure the purchaser that he, the vendor would not later enter into competition. Difficulty lies in definition of the time during which, and the area within which, the non-competitive covenant is to operate, but if these are reasonable, the courts will normally give effect to the covenant." A different situation, at least in theory, obtains in the negotiation of a contract of employment where an imbalance of bargaining power may lead to oppression and a denial of the right of the employee to exploit, following termination of employment, in the public interest and in his own interest, knowledge and skills obtained during employment.

Mr. Justice Dickson was not addressing himself to the question of why the courts would void a covenant in the sale of a business. However, in the employment context unconscionability was the stated rationale behind the common law rules.
It follows then, that Dickson J. may be implying that unconscionability is also the motivation behind the rules respecting covenants in the sale of a business. The implication is that restrictive covenants in the sale of a business are struck down less often because unconscionable circumstances arise less often.

There are several questions raised by the proposition that courts should strike down restrictive covenants in sales of goodwill only when this is necessary to protect the seller from an unconscionable transaction. First, the sale of a business almost always involves negotiations between businessmen who presumably have financial and legal advice. The reported cases typically do not involve covenantors who are inexperienced business people with few financial resources.\(^75\) If business people include a restrictive covenant as part of a deal following negotiations, the court would seem to be rewriting the contract and enriching the seller by voiding the restrictive covenant.

Second, the courts will not consider the adequacy of the consideration paid for the restrictive covenant.\(^76\) If the courts were concerned with unconscionability presumably they might inquire as to whether or not the consideration paid was a fair price. On the other hand, this lack of attention to the adequacy of consideration is apparent in traditional contracts cases, where courts have disallowed agreements explicitly on the grounds of unconscionability.\(^77\) It may be then that the courts are considering unconscionability albeit misguided.

In conclusion, it is difficult to see how unconscionability can be considered to be a useful explanation for the rules which void restrictive covenants which are ancilliary to the sale of a business. It is difficult to think of a type of transaction where parties are more likely to be informed, sophisticated, properly advised and generally dealing from roughly equal bargaining positions.
(iii) Protection of Consumers

It could be postulated that the courts are not really interested in preventing an unconscionable transaction, but rather are concerned with protecting the public. The second branch of the Nordenfelt test seems at first glance, to support this view. The second branch states that the covenant must be reasonable with reference to the public interest. However, this public interest requirement is often interpreted in terms of the "pernicious monopoly" test. No reported Canadian or British cases involve covenants which have been struck down because they created a "pernicious monopoly".

Some cases have struck down restrictive covenants on general public policy grounds reflecting special circumstances (e.g. freedom of the press, accessibility of medical services.

However, it could be that in interpreting the reasonableness of the covenants as between the parties (the first branch) the courts are really concerned with protecting the public interest in free competition. As Dickson, J. stated in Ilsley: 78 As in many of the cases which come before the courts, competing demands must be weighed. There is an important public interest in discouraging restraints on trade, and maintaining free and open competition unencumbered by the fetters of restrictive covenants. On the other hand, the courts have been disinclined to restrict the right to contract, particularly when the right has been exercised by knowledgeable persons of equal bargaining power."

The above statement suggests that restrictive covenants are struck down to promote "the public interest in ... maintaining free and open competition..." Let us translate the common law rules into economic terms.

Typically, the courts strike down restrictive covenants because they are too wide. For example, suppose that a firm has goodwill and an established brand name in Ontario but is not known outside Ontario. If
the firm is sold, the courts will allow a restrictive covenant which prevents the seller from operating in Ontario. They are unlikely to enforce a covenant which prevents the seller from operating in the rest of Canada. In the terms of diagrams 1 and 2, on page 18, the seller in past years has made an investment in a brand name which has rotated the demand curve facing that firm so that it is downward sloping. The seller therefore reaps excess profits equal to the shaded rectangle. He has sold the shaded rectangle and promises not to compete in Ontario in order that the buyer can obtain this rectangle. However, if the seller promises not to compete in the rest of Canada, he is reducing the number of potential competitors that the buyer will face in the rest of Canada. If the market outside of Ontario was characterized by the situation in diagram 1 before the sale, the covenant not to compete outside of Ontario has rotated the demand curve and given the buyer some monopoly power. That is, a potential competitor has been removed. An increase in price will now not bring as rapid an influx of new sellers.

We could say that the promise not to compete in Ontario facilitates the sale of the excess profits (shaded rectangle) by ensuring that the demand curve will remain downward sloping. The promise not to compete in the rest of Canada rotates the demand curve and creates excess profits. In other words the removal of one competitor has made consumer demand more inelastic (i.e. less responsive to price).
We can distinguish then between situations in which a promise by a seller not to compete is made to protect the goodwill of the buyer, and situations where the promise is made simply to restrict the supply of a good or service and give the buyer monopoly power.

It could be then that the courts are attempting to ensure restrictive covenants are not used to created monopoly power and are therefore protecting consumers. Consumer protection could certainly be promoted by striking down a restrictive covenant that was one of a series of restrictive covenants which together gave the buyer a monopoly. We have seen that cases of this nature have been reported in the United Stated. However, where the restrictive covenant is merely one restrictive covenant in isolation there are theoretical difficulties with postulating a consumer protection rationale.

Most importantly, in a relatively competitive market the loss of one firm will have little impact on the market. If the loss of one seller did cover market power on the remaining firms we would expect other new firms to be attracted by the excess profits and enter the industry. The contrary argument is, of course, that if a market is characterized by few sellers, the loss of one seller may make a difference, except in the long-run when we would expect entry to dissipate any excess profits. In the short-run, however, consumers will suffer
from the lack of competition. Rather than have the courts distinguish competitive from concentrated markets, it may save judicial resources to have the courts void all covenants which are broader than is necessary to protect a brand name.

It is difficult to resolve this issue. Once again, the debate revolves around one's views of the marketplace. If one believes that most markets are competitive and that excess profits are quickly dissipated by new entry then one would not consider the law of restrictive covenants to be furthering economic efficiency. If, on the other hand, one considers that many markets are not very competitive then the law could be seen as acting to make them more competitive.

In attempting to resolve the issue one might pose the following question: "If markets are so competitive, and therefore restrictive covenants can only be used to protect goodwill why would buyers require and presumably pay for restrictive covenants which are much wider than is necessary to protect goodwill?" The easy answer to this question is: the firms buy these wide covenants in order to gain market power. However, two alternative answers are:

(1) The courts may define goodwill improperly and void covenants which are only protecting a brand name. Even if a firm does not carry on business in Alberta it may have a reputation in Alberta.
(2) The firms save transaction costs by simply drawing a large area rather than precisely the area necessary to protect goodwill. This argument assumes that the ability to carry on business in a new area is of very little value to the vendor.
We can further muddy the waters by considering that even where a restrictive covenant is used to protect goodwill it may help the buyer gain market power. One seller has been removed from the market making the market less competitive. Of course, if the buyer is a new entrant to the industry there has been no change providing of course that the entrant would not have been prepared to enter the industry except by buying out an existing seller with a restrictive covenant attached.

The matrix below summarizes the impact of enforceable restrictive covenants on the number of competitors in all situations.

<table>
<thead>
<tr>
<th>Seller in Market</th>
<th>Seller is not in Market (potential entrant)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buyer in market or would enter without a covenant</td>
<td>Loss of one competitor</td>
</tr>
<tr>
<td>Buyer entering market and would not enter without a covenant</td>
<td>No change</td>
</tr>
<tr>
<td></td>
<td>(Allowed by Courts)</td>
</tr>
</tbody>
</table>

The courts allow restrictive covenants in cases described on the left side of the matrix and disallow those cases described on the right side. We could argue that even if we are concerned about consumer protection, we should allow restrictive covenants in
quadrant (1,1) since any loss of competitiveness is offset by the gains inherent in allowing investment in brand names.

However, it may be that the courts should enforce restrictive covenants even where the seller has not participated in the market if the buyer can prove that he would not have entered the market without such a restrictive covenant (quadrant 2,2).

To make matters even more complex, if the courts are interested in promoting economic efficiency they should consider more than just the loss of competition. It may well be that a transaction where one entity purchases a business and a restrictive covenant from another entity creates a larger firm which can realize substantial economies of scale. These scale economies may lower the cost of producing the goods in question and leave society better off.

(iv) Paternalism

It could be argued that the rule forbidding restrictive covenants exist, to protect the liberty of men to trade. The Privy Council stated in the Vancouver Malt case: 7

"The receipt of a sum of money can generally be shown to be advantageous to a businessman, but his liberty to trade is not an asset which the law will permit him to barter for money except in special circumstances and within well recognized limitations."

In Nordenfelt, Lord MacNaughten spoke of "the two principles which have to be adjusted in all these cases - freedom of trade and freedom of contract. 10

The law then could be promoting a kind of paternalism. The law could be saying that liberty to trade is a freedom that the law
will protect regardless of whether or not the individual wants this liberty.
Conclusion

We are left it seems with three unattractive explanations for why courts strike down restrictive covenants in cases involving the sale of a business. The courts may be trying to prevent unconscionable transactions. However, it would be difficult to conceive of a situation where the parties are more likely to be experienced, cautious and represented by legal counsel.

Secondly, the courts could be promoting competition in order to protect the public. However, the analysis necessary to correctly predict the impact on economic efficiency of a given restrictive covenant is certainly absent from the reported decisions and may be beyond the ability of our courts.

Thirdly, the courts may be simply promoting paternalism. They may not let us barter with our freedom to trade. This third explanation too does not bear up under close scrutiny. Given the maze of regulatory agencies, statutes and other bureaucratic controls which dominate our markets, only the most ardent of libertarians can maintain today that the freedom to trade is sacred.

We have then a body of law, which occasionally strikes down a restrictive covenant for reasons which largely defies explanation. To the authors the most persuasive argument is that the common law is attempting to promote economic efficiency albeit in an imperfect and haphazard fashion.
Footnotes

1. The earliest reported case dealing with restraint of trade is The Dyer's Case (1414), Y B.2 Hen. V., fo 5.


6. Ibid., at p. 41.

7. (1614), 2 Bulst. 136

8. Mitchell v. Reynolds (1711), 1 P. Wms. 181


11. 1 P. Wms. 181 at p. 185 (as quoted in Heydon, op. cit, p.14)

12. See for example Bryson v. Whitehead (1822) 1 S. & S. 74; Wallis v. Day (1837) 2 M & W 273; and Kimberly v. Jennings (1836) 6 Sim. 340

13. [1894] A.C. 535

14. Ibid., at p. 565

15. [1934] 1 W.W.R. 471 at 475 (P.C.)


17. [1978] 2 S.C.R. 916

18. Ibid. at p. 926


20. Ibid. at p. 621


22. (1964), 47 D.L.R.(2d) 313 (O.H.C.)

23. Ibid., at p. 319

24. (1976), 536 S.W. 2d 631 (Texas Appeals Ct.)
25. Ibid, at p. 634
27. [1916] A.C. 688
28. Ibid, at p. 709
29. See for example Connors v. Connors Bros., Ltd, (1941) 3 W.W.R. 666 (P.C.)
    Huberman v. Hadath (1972), 13 C.P.R.(2d) 253 (B.C.S.C.)
30. Ibid
31. (1932), 160 A. 379
32. Supra, note 22, at p. 319
33. Supra, note 28, at p. 684.
34. Supra, note 19, at p. 617
35. Ibid
36. Ibid at p. 618
37. Ibid at p. 621
38. (1963), 41 D.L.R.(2d) 242
39. Ibid, p. 247
40. (1978), 5 B.L.R. 132 (O.C.A.)
41. Ibid, at p. 145
42. Supra, note 28 at p. 685
43. See for example Day Companies v. Patat (1968), 403 F.2d 792
44. [1893] 1 Ch. 630 at p. 668.
46. Supra note 18 at p. 620
47. Supra note 16 at p. 929
48. Supra note 16, at p. 928
49. Supra, note 28 at p. 685
51. Supra, note 39 at p. 150
52. (1981), 34 N.R. 168, (S.C.C.)

53. Ibid, at p. 178

54. Ibid, at p. 177

55. Supra, note 28

56. Supra, note 39 at p. 150

57.

appeal to S.C.C. refused 9 C.P.R. (2d) 119n (Can).

59. See C.T. Drechsler, Annotation - Enforceability of Covenant against
competition, ancillary to sale or other transfer of business, practice or
property, as affected by territorial extent of restriction, 46 A.L.R. 2d
119 at 263. See also 45 ALR 2d 77 at 186 which is a similar annotation
entitled: Enforceability of covenant against competition, ancillary to sale
or other transfer of business, practice, of property, as affected by
duration of restriction. References to this footnote will be references to
the first annotation.

60. Ibid.

61. But see Drechsler, ibid., at p. 269 and the cases cited therein for the
opposite view.

62. Ibid. at p. 270-275; Tinio F.S., Annotation - Validity and Construction of
Contractual Restrictions on Right of Medical Practitioner to Practice, to
Sale of Practice. 62 ALR 3d 918.

63. (1956) 8 Ill 2d 351, 134 N.E. 2d 329 at 331.

64. Ibid.

65. (1923, Tex Civ App) 254 SW 402 at 403.

66. Supra note 59 at p. 275.

67. Ibid.

68. Ibid. at p. 288. See especially Consumers Oil Co. v. Nunnemaker (1895) 142
(1899) 182 Ill 551, 55 NE 577, 64 LRA 738, 74 Am. St Rep 189, error dism &
187 US 651, 47 L ed 349, 23 S Ct. 841; Lufkin Rule Co. v. Fingeli (1989)  
57 Ohio St 596, 49 NE 1030, 41 LRA 185, 63 Am St Rep 736; Western Wooden-ware
Asso v. Starkey, (1890) 84 Mich. 76, 47 NW 604, 11 LRA 503, 22 Am St Rep
686.

70. Ibid at SW 603
71. Ibid
72. Ibid at 605
73. PV =


75. See for example, Re Giannone and Stampdedr Motor Hotel discussed at Pt. 38 supra where the convenant was struck down. There is no indication that the covenants were inexperienced or lacked resources.


78. Supra, note 2, at 923.
