# Franchising - Canada

## Restrictive covenants and non-arm's-length third parties

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### Introduction

Non-compete and non-solicitation provisions are common in commercial contracts. Such provisions are of particular importance in the franchise context, as a franchisor provides a franchisee with confidential information, training, assistance and knowledge on how to succeed in a particular venture. If a franchisee were free to use this information and knowledge to compete with the franchisor or the other franchisees, the financial and other interests of the franchisor, its franchised system and the other franchisees could be prejudiced and the financial value of the franchised system could be significantly diminished.

### Facts

In *PetValu Canada v 1381114 Ontario Limited* (2013 ONSC 5361) franchisor PetValu sought an interim injunction against defendant franchisee 1381114 Ontario Limited and its sole director and officer Robin Martin, as well as her husband Mark Fingarson and his company 2347687 Ontario Limited, to prevent them from breaching the non-compete and non-solicitation provisions relating to a franchise agreement with Petvalu that were undertaken by the defendant franchisee and its sole director and officer.

These provisions prohibited both the defendant franchisee and its sole principal from:

- participating in a competing business for two years after the expiration of the franchise agreement; and
- hiring or seeking to hire an employee of any PetValu franchise for one year after the expiration of the franchise agreement.

The franchised PetValu business was in operation until termination of this franchise agreement on July 3 2013.

The principal informed PetValu on June 20 2013 that it had transferred its assets to a numbered company, although it had previously agreed to transfer them to the franchisor. Less than one month before termination of the franchise agreement, Fingarson incorporated a company, registered the business name Pet Stuff & Supplies and set up a pet supply store 450 metres from a PetValu franchise. This pet supply store then employed a manager who had previously been employed by the defendant franchisee. In addition, various assets of the defendant franchisee (eg, racking, price tags and inventory) were found in the competing pet supply store. The franchisor also provided private investigator evidence that Martin was present at her husband's new store twice a day.

The defendants argued that Martin was not operating the new store; nor was she employed by it. She was in no way the controlling mind of the operator of the new pet supply store which, in any event, did not compete because it also sold spy equipment and skateboards.

### Decision

The Ontario Superior Court of Justice determined that while Fingarson was not a party to the franchise agreement, he incorporated the new entity and started operating a new pet supply business in order to assist Martin in competing with the plaintiff and thereby avoid breaching her non-compete and non-solicitation covenants. The judge found that

there was clear evidence that Martin was actively involved in the new business.

The injunction to compel Martin, Fingarson and his company from ceasing to compete was thus granted.

**Comment**

The court has sent a clear message that it will look past transparent and ill-advised methods of working around non-compete and non-solicitation covenants.

A new and interesting facet of this case was that the injunctive relief was also granted against the husband and his company, despite them not being a party to the franchise agreement or being otherwise bound by any non-compete, non-solicitation or confidentiality covenants.

Previously, the furthest that the courts had gone was to use the theory of corporate alter egos to bind principals of a corporate franchisee to restrictive covenants undertaken solely by the franchisee on the basis that these covenants would be effectively meaningless if the principals could simply incorporate a new company with which to compete.

While the decision is novel in its approach, the facts of this case involved a member of the franchisee's immediate family, and it may be questioned whether the willingness to bind non-signatories to restrictive covenants could be extended to anyone else. However, the decision may open the door for potential claims against other non-parties who actively participated in the franchised business and who subsequently assist a party subject to restrictive covenant to circumvent it.

The other interesting facet was the court's overview of the law surrounding injunctions relating to restrictive covenants. Anyone seeking injunctive relief must demonstrate that:

- if the injunction is not granted, it will suffer irreparable harm, meaning that compensation in damages will be inadequate; and
- its harm if the injunction were not granted would outweigh the harm to the defendant if it were granted, known as the 'balance of convenience' test.

However, the court recognised that "a fundamental aspect of any franchise system is the protection of its method of operation, goodwill, products and services". As such, where there is clear breach of a negative covenant (including a restrictive covenant) in a franchise agreement, the elements of irreparable harm and balance of convenience are not required (although the court nonetheless found that there was significant evidence to meet these requirements. All that is required is to show a valid and supportable claim for breach of a restrictive covenant.

This decision is positive for franchisors as it demonstrates the court's willingness to enforce restrictive covenants even against a third party to a franchise agreement if it is demonstrated that such third party is not at arm's length with the ex-franchisee and is aiding the ex-franchisee in breaching its restrictive covenants.

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