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# Restrictive Covenants in Franchising

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## 1. Introduction

Restrictive covenants ("RCs") are very common in franchise, agency and distribution agreements. They seek to protect goodwill and customer relationships by limiting the licensee's right to operate a competing business both during the term and after the termination or expiry of the agreement. RCs will typically comprise of undertakings of non-solicitation, non-dealing, confidentiality and non-competition and have a specific duration and/or geographical reach. RCs can be vital in protecting the integrity of a brand's network.

Two recent cases in the English Courts have considered the enforceability of RCs. In the case of Prophet Plc v Huggett (the "**Prophet Case**"), the Court of Appeal overturned a decision in the High Court, which had taken an unorthodox approach to an incorrectly drafted post termination RC in an employment contract. In Carewatch Care Services Limited v Focus Caring Services Limited & Others (the "**Carewatch Case**"), Mr Juctice Henderson considered (and upheld) the enforceability of standard post termination RCs in a franchise agreement, as a matter of common law and under principles of EU and UK competition law.

This article will consider the background of RCs in the context of franchising and discuss the implications of both judgments.

## 2. Background

### Competition Law

EU and UK competition law prohibits agreements which have as their object or effect the restriction of competition and which may affect trade between Member states/within the UK. For most practical purposes EU and UK competition law can be regarded as the same. For a long time it has been recognised (since the European Court of Justice (ECJ) *Pronuptia* case in 1986) that provisions in franchise agreements restricting the business conduct of franchisees both in– and post term fall outside the scope of competition law as long as they are:

- Essential for protecting the know-how transferred by the franchisor to the franchisee and/or;
- Essential for maintaining the identity and reputation of the franchised network.

In *Pronuptia,* the ECJ recognised that clauses preventing the franchisee from competing with the franchisor or other members of the franchised network for the duration of the franchise agreements and for a reasonable period after termination would be essential for protecting the franchisor's know-how.

Restrictive clauses that do not meet these tests may nevertheless fall outside the prohibition on anti-competitive agreements if:

- The agreement is "de-minimis" i.e. where the market shares of the franchisor and franchisee are each 15% or less, provided the agreement contains no restrictions of competition by object (or 'hard-core' restrictions, which are mainly pricing, territorial and resale restrictions). Following the publication of the new De Minimis Notice by the European Commission in June 2014, the reality is that SME franchisors cannot take for granted protection from the de-minimis exemption;
- The agreement falls with the "Vertical Restraints Block Exemption" (**"Block Exemption**") which exempts distribution agreements generally (including franchise agreements) provided that neither the franchisor nor the franchisee has a market share of more than 30% and so long as the agreement contains no hard core restrictions.

The Block Exemption coverts in-term non-complete clauses provided that they are of no more than 5 years' duration. Post-term non-compete clauses are covered only in very limited circumstances that are of little practical use to most franchisors.

Franchise agreements are often drafted solely to come within the Block Exemption and therefore miss the opportunity afforded by the more favourable approach towards non-compete clauses in *Pronuptia.*

### The English Law Perspective: Restraint of Trade

The English law of restraint of trade is also applicable to non-compete clauses. It sits alongside competition law and needs to be considered separately. In the case of an agreement with a purely UK dimension, a non-compete clause may be struck down either on competition law or on restraint of trade grounds. Where an agreement has a potential effect on trade between EU Member States, the EU competition law analysis will prevail.

Covenants in restraint of trade are prima facie unenforceable unless it is shown that they are intended to protect a legitimate purpose and that they extend no further than reasonably necessary to achieve that purpose.

Restraint of trade is wider than competition law in its application to non-compete clauses. It covers relationships, such as that of employer/employee or principal/agent, which are not caught by competition law at all. It is also wider because the English Courts will recognise a wider range of legitimate interests that can be protected than the two factors mentioned in *Pronuptia,* for example, goodwill, loyalty to the brand, loyalty of the franchisee's employees.

The English Courts recognise that it would be extremely difficult for a franchisor to find a new franchisee if a former franchisee, with all his or her previous experience, knowledge and contacts in the area, was free to compete in the same area as soon as the franchise agreement expired or was terminated.

In the case of post-termination non-competes, the Courts will normally not allow the restriction to extend for more than one year after termination and not beyond the former franchisee's territory. In this respect competition law is somewhat more generous to franchisors since, where there is valuable know-how to protect, a post term restriction may extend to any other

franchised area.

The English Courts will judge each case by its own merits and they will enforce well drafted RCs provided that they go no further than is reasonably necessary to protect the franchisor's legitimate business interests.

### Consequences of getting it wrong

To be enforceable, RCs in franchise agreements must therefore strike a delicate balance between protecting the franchisor's legitimate business interests and at the same time not being overzealous in their scope and duration. Where a Court finds that a RC is either an unreasonable restraint of trade or is anti-competitive, the RC will be unlawful and unenforceable. This will cause the entire franchise agreement to be unenforceable unless the RC or the offending part of it can be removed (or "severed") from the rest of the agreement. The Court will only sever and unenforceable provision if:

- it is capable of being removed without the necessity of adding to or modifying the wording of what remains (the "Blue Pencil" test);
- the remaining terms continue to be supported by adequate consideration; and
- the removal of the unenforceable provision does not so change the character of the contract that it becomes 'not the sort of contract that the parties entered into at all'.

RCs that fall foul of competition law also risk exposing the parties to the agreement to investigation by the UK or EU competition authorities and fines for infringement of the competition rules. A franchisee that suffers loss as a result of an anti-competitive RC may also have a damages claim against the franchisor.

## 3. Analysis

### The Prophet Case

In this recent case on the English law of covenants in restraint of trade, the relationship between the parties was that of employer and employee, but the law in this area is relevant to the franchisor/franchisee relationship. The non-compete RC was for 12 months and the High Court at first instance, unusually, corrected a drafting error by adding wording to make the RC valid. However, the Court of Appeal rejected the approach taken by the High Court and reaffirmed the Courts' usual approach to construe ambiguities in a contract against the party seeking to rely upon them and to refrain from re-drafting clauses to make them enforceable and achieve their intended purpose.

Prophet Plc ("**Prophet**") specialises in the development of computer software for the fresh produce industry. Mr Huggett was employed by Prophet as its UK sales manager and was responsible for developing new business in the fresh product industry and an accounting relationship management with Prophet's existing customers. Mr Huggett's contract of employment contained standard post termination RCs but, at the end of the non-compete RC, the draftsman had included an additional sentence providing that the restriction *"shall only operate to prevent the employee from being so engaged, employed, concerned or interested in any area and in connection with any product in, or on, which he / she was involved whilst employed hereunder"*. Read literally, the clause gives no protection to Prophet because no competitor would ever be selling Prophet's products, which were the only products which Mr Huggett could have been involved in whilst employed by Prophet.

Mr Huggett resigned from Prophet and sought employment from K3 Business Solutions Limited ("K3"), a software supplier operating in direct competition with Prophet. Prophet agreed to release Mr Huggett early from his notice period but sought undertakings that he would not start his employment with K3 until January 2015. Mr Huggett declined to give that undertaking but instead had given an undertaking which was in the terms set out in his contract of employment. Not satisfied with this, and no doubt aware of the drafting error within the non-compete RC in Mr Huggett's contract of employment, Prophet sought injunctive relief.

Judge Donaldson QC was unimpressed by Mr Huggett as a witness and, perhaps influenced by this, sought to re-draft the non-compete RC to make it enforceable by adding the words "or similar thereto" at the end of the clause.

The High Court regularly turns down applications to enforce badly drafted post-termination restrictions. Sometimes, RCs are saved by use of the Blue Pencil Rule, but in this case, the High Court at first instance adopted a different approach and went further by adding words to the RC to make it reflect what Judge Donaldson QC considered "a reasonable person would have understood the parties to have meant".

This approach was, however, rejected by the Court of Appeal who decided that the wording could not have been clearer and had simply been poorly drafted and did not merit a rewrite; Prophet

"made its…bed and it must now lie upon it".

### The Carewatch Case

In the Carewatch Case, a franchisee had established a competing business and when the parties were unable to resolve the issues between them, both sides sought to terminate the franchise agreement. The franchisee challenged the enforceability of the post termination RCs in the franchise agreement (which were fairly standard) under both restraint of trade and competition law.

In considering the position under restraint of trade, the judge, Mr Justice Henderson emphasised the franchisor's legitimate interest in preventing competition by a former franchisee against its other franchisees and in retaining customer loyalty built up by the former franchisee. He upheld as reasonable all the franchisor's post-term non-competes, the duration of which ranged between 9 to 12 months, which covered not only businesses directly competing with the franchised business but also similar business, and which in one case extended in a limited fashion beyond the former franchisee's franchised territory.

In relation to competition law, the judge applied the criteria in *Pronuptia* case and again upheld all the RCs. The central question was whether the franchisor's know how provided to the former franchisee was of an extent and type likely to turn the franchisee into an effective competitor of the franchisor. The judge held that this was the case even though the former franchisee has had its franchise agreement for a long time and was highly experienced at running the business.

## 4. Takeaway points

The Prophet Case re-affirms the English Court's approach to construing ambiguities in a contract against the party seeking to rely upon them and the Court's unwillingness to re-draft RCs to achieve their intend purpose. Franchisors should ensure that the terms of their RCs accurately reflect the intentions of the parties at the time they are entered into and that they are tailored to the individual circumstances, such as that they go no further than is reasonably necessary to protect the legitimate interests of the franchisor. The Carewatch case is a timely reminder of the interplay between competition law and RCs and the scope for defending RCs on the basis of protecting the franchisor's know-how.

It is important to ensure that, in the case of corporate franchisees, the key individuals and not just the corporate franchisee are bound by the RCs – this can be done by joining them as a party to the franchise agreement or having separate "deeds of undertaking" between the franchisor and the relevant individuals.

RCs in franchise agreements need to be carefully drafted and regularly reviewed by an experienced lawyer to ensure their enforceability and avoid any inadvertent loss of protection.

If you would like more information on this topic, please contact your usual franchise team member or Gordon Drakes (Senior Associate) or Neil Johnston (Director).

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