

ENFORCING RESTRAINT OF TRADE CLAUSES IN FRANCHISE AGREEMENTS

Franchise agreements often include restraint of trade clauses to prevent a franchisee from competing with the business and the franchisor during and after the term of their franchise agreement. This means that a franchisee is restricted from starting up a competing business during or after the term (for a limited period) or de-badging their store at the expiry of their franchise agreement and continuing to conduct business under a new name at that location.

When the new Franchising Code of Conduct (new Code) took effect on 1 January 2015 it brought significant changes to the enforceability of restraint clauses in franchise agreements entered into, renewed, extended or varied after 1 January 2015.

Unless an existing franchise agreement is renewed, extended or varied after 1 January 2015, the old Code will apply. Therefore there are two distinct situations:

1. Agreements pre 1 January 2015; and
2. Agreements post 1 January 2015.

The Purpose of Restraint Clauses

Franchisors invest a lot of resources into establishing their systems and brand. Restraint of trade clauses are used in order to protect a franchisor's commercial interests in their goodwill and trade know-how. It also gives the franchisor time to "bed down" a new franchisee in the area.

During the term the restraint is for a number of reasons. Firstly, the franchisor does not want the franchisee to use the franchisor's systems, procedures or intellectual property in a competing business. Secondly, the franchisor wants the franchisee to devote their time and attention to the operation of the franchised business.

Restraint clauses will operate for a set time period to cover a specific geographical area or territory. They will often extend to prevent a franchisee from soliciting customers and employees of the franchise system. At the expiry of a franchise agreement, a franchisee will only be permitted to work in or conduct a competing business which is outside of the restraint area. Once the restraint period expires, the franchisee will then be free to work in or conduct a competing business within the restraint area, provided that they do not use or infringe upon the franchisor's intellectual property or confidential information.

If a franchisee breaches a restraint clause, a franchisor can take legal action to enforce the clause, and/or seek compensation from the franchisee for any loss or damage suffered. The franchisee may also be liable for the franchisor's legal costs. Generally restraint clauses are enforced by an application for an injunction to restrain the franchisee from breaching the clause. Breach of an injunction can have serious consequences. In one case, a franchisee continually breached the Court order and was sent to jail for 3 months. The jailing was not for breaching the restraint in the first place but for breaching the Court order. Courts do not like their orders to be ignored!



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Enforceability

Subject to meeting the drafting requirements outlined below, a restraint clause in a franchise agreement entered into, renewed, extended or varied before 1 January 2015 may be enforceable.

A restraint of trade clause in a franchise agreement entered into, renewed, extended or varied on or after 1 January 2015 will **not** be effective if:

- a. the franchisee had given written notice to the franchisor seeking to extend the agreement on substantially the same terms as those:
 - i. (i) contained in the franchisor's current franchise agreement; and
 - ii. (ii) that apply to other franchisees or would apply to a prospective franchisee; and
- b. the franchisee was not in breach of the agreement or any related agreement; and
- c. the franchisee had not infringed the intellectual property of, or a confidentiality agreement with, the franchisor during the term of the agreement; and
- d. the franchisor does not extend the agreement; and
- e. either:
 - ii. (i) the franchisee claimed compensation for goodwill because the agreement was not extended, but the compensation given was merely a nominal amount and did not provide genuine compensation for goodwill; or
 - iii. (ii) the agreement did not allow the franchisee to claim compensation for goodwill in the event that it was not extended.

This new provision does not mean that all restraint clauses in franchise agreements entered into after 1 January 2015 will be ineffective. It will only apply at the expiry of a franchise agreement if all criteria (a) to (e) are met. The provision also does not restrict a franchisor from enforcing a restraint of trade clause against a franchisee during the term of a franchise agreement. Clauses restraining a franchisee from infringing the intellectual property of the franchisor will remain enforceable during and after the expiry of the term of a franchise agreement.

Drafting Restraint Clauses

The legal phrase that is generally used for restraint clauses is that they are *prima facie* void and will only be enforceable to the extent they are reasonable and necessary to protect the franchisor's legitimate business interests. That means that the court starts with the presumption that the clause is void and then goes on to see whether or not the restraint will be enforceable because it is reasonable and necessary to protect the franchisor.

Many restraint clauses are enforceable.

They must be carefully drafted in order to balance:

1. The need to protect a franchisor's business interests;
2. The franchisee's right to earn an income; and
3. The public's interest in ensuring a competitive market place.



A clause which extends beyond protecting a franchisor's legitimate business interests may be held to be unenforceable. To prevent an entire restraint clause being unenforceable, they are drafted as a cascading clause in franchise agreements. This is a clause with several different restraint options. The options begin by restraining wide areas for long time frames to narrow areas for short time frames. If a Court was to find a wide restraint unreasonable, then a narrower restraint could be valid. An example of a cascading clause could be:

- a. 10 kilometre radius;
- b. 5 kilometre radius;
- c. 2 kilometre radius.

during the following period:

- i. 5 years;
- ii. 3 years;
- iii. 2 years.

So the court would look at 10 kilometres for 5 years and say that is too much. Then 5 kilometres to 3 years and decide if that is too much. Each of the options is used until the court determines if one is enforceable. The final outcome could for example be 5 kilometres for 3 years.

Franchisors should be aware that customer lists will not generally be considered as confidential information unless specifically stated to be so in the documents. A franchisor can nominate a customer list as confidential information and incorporate this into the franchise agreement or have a special provision in the restraint clause.

Some Recent Court Decisions



A restraint clause will not be enforceable if it goes beyond what is reasonable to protect a franchisor's interests or if there is already another way of protecting those interests. Take note that the following decisions are in regard to franchise agreements falling under the provisions of the old Code – the old Code did not have restrictions on restraint clauses.

At the expiry of a franchise agreement in the 2012 case of *Murray Pest Management Pty Ltd v A & J Bilske Pty Ltd*, the Northern Territory Supreme Court found an entire restraint clause unenforceable because it was unreasonably wide. The clause prevented a pest control franchisee from having any interest in a similar business within the franchisee's territory or the territory of another franchisee, as well as within a 5 kilometre radius of those territories.

The Court found these restraints to be too wide because they prevented the franchisee from having any personal interest in a competing business in an area that covered tens of thousands of kilometres. The franchisee's business did not operate in that large area. It was restricted to only a small part of the territory covered by the franchise agreement. The clause was too wide and it could not be cascaded down as the appropriate options were not in the franchise agreement. The franchisee was permitted to compete against the franchisor immediately after the expiry of the franchise agreement.

In *Murray*, the Court also reflected that the franchisor and franchisee had separate businesses, each with their own goodwill. If a franchisee's business attracts its own good will, and they then compete with the franchisor, this will not necessarily detract from the goodwill of the franchisor. This will be determined on the facts of each case.

Courts are often willing to uphold a basic restraint of trade clause that is on reasonable terms. In the 2012 case *Sidameneo (No 456) Pty Ltd v Alexander*, the New South Wales Court of Appeal held that a medical centre's restraint clause which prevented doctors from practicing medicine within 3 kilometres for one year after the franchise agreement ended was enforceable.

The New South Wales Court of Appeal in the 2010 case of *BB Australia Pty Ltd (Blockbuster) v Karioi Pty Ltd* found that a restraint clause was unenforceable as there was not enough goodwill in the franchisor's business to support a restraint. Before entering into the franchise agreement, the franchisee converted two privately owned video stores into Blockbuster franchises. After the expiry of the franchise agreement, the franchisee de-badged and continued to operate the stores. The franchise agreement had a 2 year restraint within 30 kilometres of the stores. The Court decided that other clauses in the franchise agreement already gave sufficient protection to the franchisor's intellectual property. Blockbuster did not have sufficient goodwill because the franchisee already held its own goodwill in the stores prior to becoming a franchisee.

It should be noted that the situation in the Blockbuster case is rare as more often, franchisees do not have their own stores that are converted to a franchised store. Usually the stores are set up as franchised operations.

EzyDVD Pty Ltd v Lahrs Investments Qld Pty Ltd & Ors shows the importance of having a carefully drafted restraint clause. In 2009 the Queensland Supreme Court found a restraint clause to be unenforceable because the intention of the clause was to protect the confidential information and intellectual property of

the franchisor. The clause made no mention of the franchisor's goodwill. The Court found the clause was unreasonable because there were already other provisions in the franchise agreement covering confidential information and intellectual property, and the franchisee had already complied with these.

The case of *Kwik Fix International Pty Ltd v Garside [2006] QDC 69* was one where the spray painter franchisee argued that he had dependants and relied on his work for support for his family and himself. The court held that the restraint did not deny him his trade or the right to pursue work but only to cease servicing former franchise customers for 3 years. So it can be seen that the argument that a person needs to earn a living will not work if that living can be earned easily outside of the territory.

Lessons for Franchisors and Franchisees

The recent Court decisions demonstrate the importance of having a carefully worded restraint of trade clause in a franchise agreement. At the time of writing, the provisions of the new Code pertaining to restraint clauses have not yet been tested by the Courts. Give us a call if you would like an update on the case law.

At Bywaters Timms we can provide advice to a franchisor or a franchisee about appropriate restraint clauses and their enforceability.



We can help franchisors to draft or enforce a restraint clause to appropriately protect their legitimate business interests.

We can help franchisees who are faced with an unfairly wide restraint clause, or would like to know their options for continuing a business when their franchise agreement expires in light of changes brought by the new Code.

Negotiating and drafting franchising agreements is our specialty at Bywaters Timms. Ask us how we can be of assistance.