

Restrictive Covenants: Worth the paper they're written on

The recent case of PSG Franchising Ltd v Lydia Darby Ltd and others serves as a reminder of the need for caution when signing up to restrictive covenants.

The Facts

PSG Franchising Ltd ("PSG") is a franchisor which licences franchisees to use its system and know how to provide property search information typically required by conveyancers and lenders.

In May 2006, PSG entered into a franchise agreement with Lydia Darby Ltd ("the first defendant") due to last for five years from 31 March 2006. The agreement included a non-compete clause designed to restrict the activities of the first defendant for one year after the agreement had come to an end. The relevant clause stated that the first defendant could not be engaged in any business which provided "*services which compete with any of the services provided [by PSG] or any of its franchisees within the territory*", "the territory" being the postcode areas in and around Milton Keynes.

After the expiry of the term in March 2011 the parties continued to operate the franchise as if the agreement were still in place, with the first defendant continuing to use PSG's system and accounting to PSG in accordance with the terms of the agreement. From May 2012 discussions took place regarding the future of the arrangement as business had slowed down. Eventually it was agreed that the franchise would be terminated from 31 August 2012.

PSG subsequently alleged that during those discussions the defendants had lied about what they had been doing and about their future intentions. It was claimed that since at latest September 2011 they had been operating a competing business in breach of their obligations under the franchise agreement, and that they continued to do so after the termination. PSG applied to enforce the non-compete clause in the franchise agreement.

Consequences

The defendants contended that the non-compete clause in the franchise agreement was unenforceable as its wording could be construed so as to prevent them from providing the services anywhere in the UK (i.e. they raised the question of whether the clause meant that they could not provide the services *anywhere* that PSG provided in Milton Keynes). The court rejected this argument as it was clear from the natural meaning of the words that the defendants were only restricted from competing with PSG in Milton Keynes.

It was further claimed by the defendants that the non-compete clause was unreasonable because the definition of the "services" with which they could not compete included services introduced after the franchise agreement had been terminated. They argued that such a prohibition is unenforceable as they will never have benefited from those services. The judge, however, found that this argument was aimed entirely at striking down the clause so that the

defendants could compete with PSG's existing services; it would be wrong to void the clause based on a point that was both hypothetical and speculative.

The judge concluded that the scope of the restrictive covenant was no more than was reasonable to protect PSG's legitimate business interest. Accordingly, an injunction was granted to restrain the defendants from acting in breach of the restrictions.

The Lesson

In arrangements like franchise agreements, share purchase agreements and employment contracts, a party will often have a legitimate interest in including a clause that restricts the activities of the other party.

Broadly speaking, restrictive covenants are unenforceable if the courts regard them as an unreasonable restraint of trade which goes beyond what is reasonably necessary to protect the legitimate interests of the person seeking to rely on them. Generally they will need to be limited in terms of (at least) duration, geographical scope and the activities they cover.

However, this case re-emphasises that when a party enters into restrictive covenants, it should not do so lightly. Although by their nature restrictive covenants are always susceptible to a possible challenge, the courts are willing to uphold them if any arguments against them are spurious. Often these covenants can have very significant effects on a party's commercial activities and they need to be carefully considered rather than viewed as "small print" to be glossed over in negotiations.

For more information please contact:

David Webster

Partner

+44 (0)20 7440 4825

David.Webster@russell-cooke.co.uk

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