



Freeth
Cartwright
LLP

Franchise Bulletin

Winter 2010



Protecting the goodwill in a franchise - prevention is better than cure

At the heart of a franchise is the goodwill generated by the brand. This is what the franchisor has spent time and money developing and seeks to protect, in particular by the use of post-termination or "restrictive" covenants to limit the activities of former franchisees once their franchise has ended. It's crucial that these clauses are carefully drafted so that they are not too restrictive, which would render them unenforceable. A couple of recent cases have highlighted the key points to consider.

Lucie Wigham Associate
0845 274 6812

lucie.wigham@freethcartwright.co.uk

Taking care when drafting agreements

Chipsaway ran a franchise of car care businesses. Errol Kerr became a franchisee using their standard agreement. The agreement attempted to stop Kerr setting up in competition for a period of 12 months, within a specified area, after they left the franchise. When the agreement came to an end, Kerr stayed in the same area but decided to run a repair shop as a sole trader, no longer as a franchisee. Chipsaway sued.

Kerr argued that, on a strict interpretation of the wording of the agreement, the restraint of trade clause only prohibited the franchisee setting up in competition with the "Business", defined as the services performed by the franchisee. The court said that it would be nonsensical to have a restraint of trade stopping a business setting up with itself (as the franchisee would no longer exist after it set up as a new entity), and therefore re-drafted the agreement.

However the Court of Appeal decided that the intention of the parties (and a proper commercial interpretation) would prohibit the repair shop trading regardless of whether there was another Chipsaway franchisee in competition locally: Chipsaway had a legitimate interest in protecting their goodwill, regardless of whether they could find a new franchisee for the area.

Although as a last resort the court may therefore be prepared to re-draft franchise agreements to make a contract work, this is no excuse for complacency in drafting.

The Chipsaway decision was approved in a more recent judgement in the Birmingham court: **Venture UK Ltd and Image House (Photographers) and others**. Here a former franchisee worked for a company run by his wife during the period covered by the post-termination covenant.

The franchisor applied for a court injunction to stop the former franchisee and his wife's company from competing because it had developed significant goodwill as a provider of photography "experiences". The defendants to the claim argued that the period of restriction of 12 months was too long and that the restrictions were too wide - they contained a non-solicitation clause relating to customers of the former franchisee during the 12 months prior to termination.

The court decided that the covenants were sufficiently defined and reasonable to justify the injunction, not least because:

- **The geographical area covered by the restriction incorporated the marketing area defined in the franchise agreement.**
- **If a company sold a "life" experience service there was a very significant element of personal customer hold, connection and business generated from customer recommendation, all of which provided support for the existence of a legitimate interest requiring protection.**

Even though the wife's company was not a party to the franchise agreement and the post-termination restrictions it contained, the new company had knowingly and intentionally procured breaches of those covenants by employing the former franchisee in knowledge of the existence of the restrictive covenants.

So the moral is for franchisors to take care in drafting post-termination clauses: if they are reasonable they should be upheld, in which case the courts will not look kindly on former franchisees trying to get around them.

Look for those tell-tale signs

Goodwill in a franchise can diminish in various ways, not just as a result of competition from a former franchisee. In these times of recession more people are looking to go it alone and perhaps take on a franchise. Sadly, it's not a guaranteed route to commercial success and like every other business, some franchisees will fail. The key for franchisors is to spot when things might be going wrong at the earliest opportunity. What practical steps should franchisors take?

- Be aware of the warning signals and act quickly. The unexplained closure of a franchise premises is never a good sign, and unless you can contact your franchisee and he has a very good excuse it is wise to prepare for the worst.
- Review all the paperwork that you have in relation to the franchisee. As well as the franchise agreement, you will also need to locate any agreements for the supply of goods or services, and if they are leasing premises from you, the lease as well. A properly drafted set of documents will give you extensive rights.
- If it is clear that the franchisee is insolvent it is likely that you will want to terminate the franchise agreement, and it is important to do this in accordance with the provisions of the franchise agreement itself. Don't forget to terminate any other agreements, e.g. for supply of goods/trademark licences, at the same time, and if you are leasing premises to the franchisee it is likely that you will also want to terminate the lease too.
- If you cannot contact the franchisee to establish that they are insolvent you will need to consider whether you can and should terminate the franchise agreement anyway. Usually the franchise agreement will enable you to do this if e.g. the franchise premises are closed without good reason for several days.
- If you are selling goods to the franchisee and are owed money, it is likely that your agreements contain a reservation of title clause which means that you own the goods supplied to them until they are paid for. It may be that substantial quantities of what appear to be the assets of the franchise are yours, and you need to protect them. Consider stationing a private investigator outside the premises to make sure nothing is removed before you can get access to them.
- If you have properly terminated the lease, get possession of the premises as soon as possible. Make sure that you change the locks immediately. This is particularly important if your goods are in the premises and/or you want to run the franchise yourself.
- Even if you haven't terminated a lease, get into the premises as soon as possible, see what property of yours is there and obtain possession of it. The liquidator or administrator may later try to dispute what goods you have taken and their value, so make sure you are accompanied by someone independent – a surveyor or accountant – to take an inventory of the goods and their quality. If you're taking over the premises as well, do a full stock take.
- Be prepared to enforce your rights if necessary. Having rights on paper is worth little if you don't enforce them, and this is doubly so in the case of insolvency, where cash is generally in short supply.

For more information or to discuss any issues contact:

Lucie Wigham
0845 274 6812
lucie.wigham@freethcartwright.co.uk



Philippa Dempster
0115 936 9334
philippa.dempster@freethcartwright.co.uk



Whilst every effort has been made to ensure the accuracy of this bulletin, it does not provide complete coverage of the subjects referred to, and it is not a substitute for professional legal advice and should not be relied upon as such.

Banking & Finance / Business Services / Corporate Finance / Construction / Employment
Public Sector / Real Estate / Services for Individuals / Taxation

www.freethcartwright.co.uk

Offices in: Birmingham, Derby, Leicester, Manchester and Nottingham