

Hamilton Pratt Article

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NON COMPETE COVENANTS



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As every franchisor knows having effective non compete covenants is essential to maintain the integrity of a franchise system. These non compete provisions are often the most litigated clauses in franchise agreements. Generally non compete covenants in UK franchise agreements last for the duration of the franchise agreement plus a year and relate to the territory in which a franchisee has operated his franchise business.

Whilst franchisors rely on these clauses and consider them essential, competition authorities within the European Union believe that they are potentially anti competitive. It is for that reason that the block exemption for vertical agreements imposes limits on their use. Most UK franchise agreements comply with the block exemption because, in so doing, it removes any argument that the franchise agreement infringes either Article 101 of the Treaty on the Functioning of the European Union or Section 2 of the Competition Act 1998. However, in view of a recent decision of the European Court in the case of the Retoucherie Manuela SL it now appears that most UK franchise agreements do not comply with the block exemption!

Article 5.1(a) of the block exemption provides that non compete obligations that apply during the franchise agreement do not benefit from with the block exemption if they are of indefinite length or exceed five years, but the five year limitation will not apply if a franchisee sells goods or services from "premises and land" owned or leased by the franchisor in which case the five year limitation is extended to the duration of the lease. The Manuela decision has little impact on Article 5.1(a) and in-term non compete covenants.

In relation to post termination non compete covenants Articles 5.1(b) of the block exemption provides that they can be enforced but only:

- in relation to goods or services which compete with the goods or services which are the subject of the franchise;
- the covenant lasts for no more than one year following termination;
- the covenant is indispensable to protect the franchisor's know how;
- the covenant is limited to the "premises and land" from which the franchisee has operated its franchise business.

There has been uncertainty as to what "premises and land" means. That uncertainty has now been resolved by the European Court of Justice although it has been resolved in a very unsatisfactory way. The Court was asked whether these words relate only to places where the contract goods were offered for sale or to the franchise territory as a whole.

The Court drew attention to the fact that Article 4(b) refers to "restriction of the territory into which ... [a franchisee] ... may sell the contract goods or services ...". That Article according to the Court, makes it clear that when a subsequent Article refers to "premises and land" the Commission must have intended those words to mean something different to "territory" and further the Court held that a block exemption "must be interpreted restrictively".

This narrow interpretation works (sort of!) if the franchise is a retail franchise although it would not prevent, following termination, a franchisee of a retail franchise from opening a shop next door to the franchise shop and offering identical goods. Where it simply does not work is in relation to vehicle based franchises unless the vehicle is considered to be the "premises" and, if it is, then franchisees could simply obtain another vehicle to operate their competing business. For those franchises where services are provided, those services will often be provided at customers' premises and it may be arguable that "premises and land" would include customers' premises so that franchisees could be prohibited from providing similar services at those customers' premises but it appears that the European Court is in no mood to adopt a flexible approach on this point. On the face of it, franchisees can only be restricted from operating a competing business from their franchise premises.

Nevertheless, franchisors can argue that the restrictive covenant was necessary to avoid the risk of the franchisor's know how and assistance aiding its competitors and, therefore, outside the scope of both Article 101 and, for UK franchisors, Section 2 of the Competition Act. Such arguments are based on the European Court of Justice's decision in Pronuptia. This was the argument that Pirtek used successfully in Pirtek (UK) Limited v Joinplace Limited and others – a 2010 decision of the High Court.

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