

Recent cases enforce restraints of trade against former franchisees

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Two recent interim injunctions have shown the Court's ability and willingness to enforce restraints of trade against former franchisees, at least on a temporary basis. In both cases the Courts have acted to protect the franchisor's goodwill and upheld restraint of trade terms on an interim basis, until questions about the validity of the restraints can be resolved. Set out below is a snapshot of these recent cases and the legal issues surrounding restraints of trade in franchising.

Restraints of trade – an overview

Most franchise agreements contain a restraint of trade clause. These are restraints on the franchisee and its owner from competing against the franchise system. The restraints apply during the franchise and for a period after the franchise comes to an end. Restraints of trade are used to protect the franchise system's business, intellectual property and goodwill. A typical restraint of trade covers a specified business, time period and geographical area. Restraints are not enforceable unless they are reasonable.

To enforce the restraint, the franchisor must show that it has a "protectable interest" and the restraint must be no wider than is necessary to protect that interest. If a restraint goes further it may not be enforceable.

Former Mike Pero Mortgages broker barred in interim injunction

James Heath was a mortgage broker with Mike Pero Mortgages for 15 years. The Mike Pero Mortgages franchise agreement (with Mr Heath's company) contained a restraint of trade provision for 6 months for all of New Zealand and 2 years for the Canterbury region. In March Mr Heath signalled that his company would not renew its franchise. According to the court documents Mr Heath was fully aware of the restraint of trade constraints in the franchise agreement. Mr Heath and his associate Gina Smith took steps to set up a competing mortgage brokerage, James Heath Mortgages. The business plan in Ms Smith's mortgage broker accreditation application stated Mr Heath was: "Very well known in the industry and a large amount of clients from previous franchise will possibly transfer over".

The Court was satisfied that Mike Pero Mortgages had a strongly arguable claim that the franchisor had a protectable interest and a reasonable restraint of trade protecting that interest. The Court issued an interim injunction barring Mr Heath from competing with Mike Pero Mortgages until the Court could consider the matter fully at a later date. The Court stated that comparable cases involving temporal restraints on franchisees have determined that a two year restraint in circumstances where it takes two years to establish and build up the business is not unreasonable.

Former Video Ezy franchisees forced to rejoin franchise

Dunedin franchisee Red Bond Limited (RBL) was forced to rejoin the Video Ezy franchise after rebranding its three video rental stores earlier this year. The franchise agreement between RBL and VENZ included a two year non-compete restraint of trade. However, after the end of the 7 year franchise agreement between Video Ezy New Zealand (VENZ) and RBL, RBL ceased being a Video Ezy franchisee and rebranded its stores to a competing (unnamed) video chain.

The Court issued an interim injunction ruling that the three RBL stores must sever their agreements with the competitor of Video Ezy, rejoin the Video Ezy franchise and be re-branded back to Video Ezy stores until the issue could be resolved at a later Court hearing. The fact that VENZ had recently gone into voluntary liquidation and transferred its rights to another Video Ezy entity did not stop the restraint being enforced against RBL.

Franchisor perspective on restraints of trade

- Restraints of trade allow the franchisor to secure the franchise system's business and protect confidential information, intellectual property and business systems.
- The franchisor must be able to show a "protectable interest" that they are seeking to protect.
- Restraints of trade must be reasonable and go no wider or longer than necessary.

What do these Court decisions mean for franchisors?

The decisions demonstrate the Courts' willingness to enforce by way of an interim injunction *appropriate* restraint of trade provisions against former franchisees, even when there will be significant personal and/or business costs involved for the former franchisee and its owners. An interim injunction can be a useful tool for a franchisor to enforce a restraint of trade and provide the franchisor with time to install a new franchisee. The cost of bringing, and risk of losing, the later substantive Court hearing may dissuade some former franchisees from proceeding with their plans to establish a competing business.

It is important to note that these decisions do not change the existing law. The Courts have previously shown a willingness to enforce restraints of trade against former franchisees and their owners who have also agreed to be bound by the restraint. For example, these injunctions follow an August 2012 decision of the Court of Appeal which upheld a restraint of trade against a former Safe Kids in Daily Supervision Limited (SKIDS) childcare franchisee. The franchisor was able to demonstrate that it had a protectable legitimate business interest, and the former SKIDS franchisee owner was prevented from operating, albeit with a reduced restraint period. In its decision the Court of Appeal stated that:

“We have no doubt that in New Zealand a franchisor may, depending on the circumstances of the case, have an interest in a franchise that is properly protected by a restraint of trade provision.”

Some examples of factors that demonstrate a “protectable interest”

The Court of Appeal in the SKIDS decision discussed a number of factors that demonstrate a “protectable interest”. These included:

- a trading name which may have some goodwill, and give a former franchisee credibility and a cache of former customers;
- the franchisor may offer assistance on start-up to enable the franchisee to position its business in a way that is attractive to the market;
- the franchisor may offer a model of operation which is tried and tested and which attracts customers and meets their needs;
- the franchisor can offer documentation (manuals, procedures, etc.) which will assist in the conduct of the franchise's business – having documentation that is professionally prepared and updated over time will assist;
- the franchisor can offer systems such as accounting, staffing or marketing techniques, which offer advantages;
- franchisors that are involved in retail or supply can also offer specialised products.

The Jackson Russell Business Law Team helps franchisors and franchisees successfully navigate the life cycle of a franchise or licensing business model from inception through to exit. Our highly experienced team of specialists are able to provide legal and strategic advice to franchisors and large franchisees on franchising matters and most other areas of the law. We are a member of the Franchise Association of New Zealand (FANZ).



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Contact details:

Darryl King PARTNER
BUSINESS LAW TEAM
DDI 64 9 300 6935 M 64 21 326 087
E dking@jacksonrussell.co.nz

JACKSON RUSSELL
LAWYERS
ESTD 1844

Tamara Liebman ASSOCIATE
BUSINESS LAW TEAM
DDI 64 9 300 6937 M 64 21 323 843
E tliebman@jacksonrussell.co.nz

JACKSON RUSSELL
LAWYERS
ESTD 1844