


Proceed with caution – covenants in franchise agreements

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In this case, the franchisor operated the largest emergency plumbing company in the country with more than 30 franchises. The franchisee was an individual who had no previous experience in the plumbing and drainage business but invested his savings in the business and borrowed money from the bank. During pre-contract negotiations, the franchisor thought that the franchisee was an unsuitable candidate but opted to give him a chance. The franchisee paid the franchise fee and began trading in January 2019. The business was, however, much less profitable than had been indicated by the franchisor's projections and so the franchisee tried to sell the franchise but was unsuccessful. The franchisee therefore tried to terminate the agreement and started a competing business within the franchise territory. The franchisor issued a claim. At first instance, the judge held that the franchisee had committed a repudiatory breach of the agreement but the covenants were unenforceable because they were wider than was reasonably required.

The Court of Appeal confirmed that an inequality of bargaining power between the franchisor and franchisee is a significant factor when determining the reasonableness of the covenants. Where there is significant inequality of bargaining power between the parties, a franchise agreement is more akin to a contract of employment than to a contract for the sale of a business. The Court of Appeal also found that, when assessing the reasonableness of the covenants, the degree of risk undertaken by the franchisee and their personal circumstances were also factors that the court is entitled to consider. When finding that the 12-month restraint was unreasonable, the Court highlighted the need to distinguish between the position in the event of early termination and the position if the franchise had been running for the full period or a substantial portion of it, suggesting a sliding scale of restrictions as a method of promoting reasonableness.

In addition to franchise agreements, this judgment is likely to have wider implications in relation to the reasonableness of covenants in commercial contracts (such as shareholders' agreements) and in employment contracts. The restrictive covenants will need to be carefully drafted to take into account the parties' specific circumstances including their respective bargaining power, the financial/personal impact upon the covenantor during the period of the restrictions and whether a sliding scale should be used. If not properly drafted then the covenantor risks the covenants themselves being deemed unreasonable and inadvertently losing any protection.

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