

Restraint of trade clause used to shut down business

Introduction

A franchisor has used a restraint of trade clause to effectively shut down a franchisee's business after the franchisee terminated the franchise agreement.

Facts

Health Club Brands Limited (HCB) owns a business which grants franchises for *Club Physical* gyms.

Three of those Club Physical franchises were operated by three companies, all controlled by the same person.

On 8 February 2013, the three companies issued notices to HCB terminating the franchise agreements for the three gyms. They claimed that HCB had breached its obligation under the agreements to provide on-going assistance. Following termination, the gyms continued to operate under a different name.

HCB applied for an interim injunction to stop the companies from operating a health and fitness business within 5 kms of the three Club Physical gyms, until the full trial.

The franchise agreements each contained a restraint of trade clause, preventing the franchisee from operating a health and fitness business within a certain distance of the 3 gyms, and for a certain time period after termination, but the details in the clauses had not been completed. However, the agreements also prevented a new health and fitness centre in the same building as the 3 gyms, and required the franchisee to transfer the leases to the franchisor if the agreements were terminated.

The defendant said that the restraints of trade were unenforceable because the details had not been completed and because they were unreasonable. They also said that HCB should not be able to enforce the clauses because HCB was also in breach of the franchise agreements.

The Decision

The court confirmed that restraints of trade are contrary to public policy, and are therefore void, unless they are reasonable, and unless they protect a legitimate interest.

While the judge agreed that there was an issue with some of the clauses missing details, the other clause preventing a gym being operated from the same location was enforceable.

The court accepted that the restraint was reasonable to protect HCB's legitimate interest and the good will developed through the *Club Physical* brand. HCB had gone to the difficulty and expense of developing a successful business model, and was entitled to protect its investment in that business model by prohibiting franchisees from exploiting it for their own advantage, and in competition with HCB and other franchisees

The judges said that if HCB had breached the agreements so that the franchisee was allowed to cancel it, the restraint of trade may not apply. However, the judge decided that the evidence produced did not support the claim that HCB had breached the agreements.

The court then had to decide whether an injunction should be granted to enforce the restraint of trade, or whether the payment of damages would adequately compensate HCB if the injunction was not granted. The court took into account the effect on third parties of either the grant or non-grant of an injunction, and the relative strength of the parties' cases.

The Court decided that damages would not be adequate compensation, as HCB would lose the opportunity to retain customer's loyalty to the Club Physical brand. If the defendants were allowed to continue to trade in competition with Club Physical, it would be impossible for a new Club Physical gym to re-establish itself within the areas, due to the limited demand for gyms - there was not enough business in the areas to support 2 gyms.

Also, it would decrease the value of the Club Physical brand to potential new members and new franchisees, as the number of franchises would be reduced from nine gyms to six.

Other Club Physical franchisees would also be damaged, as the value of the business model they paid a franchise fee for would be reduced if the number of Club Physical gyms was reduced. If there was a delay in granting an injunction until the full trial, it would be worthless, because by that time the defendant would have established loyalty to the new brand "*Jolt Fitness*" in the franchise areas.

There was also evidence that the defendants could not afford to pay damages.

On the other hand, the grant of an injunction would be catastrophic to the defendants business, as the business would effectively have to be closed, and 40 permanent staff and 20 contracting staff would lose their jobs.

The court granted the injunction, even though it would effectively mean that the defendants business would fail as a result.

Summary

This case shows that a restraint of trade clause in a franchise agreement (or in an employment contract or sale of business agreement) can be an effective means of protecting the franchisor's business.

The case confirms that a restraint of trade clause will be enforced as long as it is reasonable, and protects property such as goodwill, a client base, or business know how or trade secrets.

Depending on the circumstances, the court will enforce a restraint by injunction, even if that means the franchisee has to close its business.

Disclaimer: This information is for general background information only and is not legal advice.