

EU, Competition and Regulated Markets

SEVERABILITY OF RESTRICTIVE COVENANTS

Restrictive covenants are often used to protect a business in various circumstances. The types of situation in which restrictive covenants are used include:

- Imposing on a vendor of a business obligations not to compete with the target business and not to solicit customers and employees of the target business;
- Co-shareholders agreeing not to compete with, and not to solicit customers and employees of, the business which they co-own;
- Employees being required not to compete with their employers business and not to solicit customers and employees of their employer's business; and
- Franchisees being required to observe similar obligations to protect the franchisor's business.

There are controls on the permitted ambit of restrictive covenants. There are two sets of independently developed rules which one needs to consider in this context namely, (i) the doctrine against restraints of trade which has been developed by the courts over a number of centuries, and (ii) Irish and EU competition law.

In summary, a restrictive covenant must be limited in time, scope and geography. If a restrictive covenant is too wide, it will not be enforceable. As a result, great care needs to be exercised when drafting such covenants with a view to ensuring that such clauses are enforceable. In practice, it is often difficult to ascertain with certainty how the rules will apply to any particular circumstance. In a recent High Court case in England, it was held that it is not possible to sever offending wording in one (unenforceable) restrictive covenant where to do so would result in changing another (enforceable) restrictive covenant in the same contract. The case highlights the need for caution when drafting restrictive covenants and to ensure as much as possible that the ambit of the restrictive covenant is refined taking account of the above controls.

Severance

Where a provision is unenforceable, severance may be used to prevent the invalidity of the entire contract. Common law allows a Judge, in certain circumstances, to sever or delete wording from a contract leaving the remaining terms of the contract in force (the "blue pencil test").

Earlier this year, severance was examined by the High Court in England in the context of restrictive covenants in the case *Francotyp-Postalia Ltd v. Whitehead and others* [2011] EWHC 367.

The *Francotyp-Postalia* Case

This case involved an appeal on a point of law to determine whether an invalid part of a post-termination restrictive covenant in two franchise agreements could be severed. The franchisor was involved in the business of the manufacture, supply, and sale of franking machines, folding machines and postal scales and the provision of maintenance services for them. The franchisees had entered two franchise



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agreements with the franchisor, the terms of which were materially identical. Following termination of the franchise arrangements, the franchisor claimed (amongst other things) damages against the franchisees for breach of post-termination covenants contained in the franchise arrangements. The covenants were designed to restrict the franchisees from competing with the franchisor's business, from supplying competing goods and from soliciting customers and employees of the franchisor.

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In an effort to ensure the enforceability of the restrictive covenants in question, the author had taken certain precautions:

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- Each restriction was contained in a separate sub-clause;
- The restrictions were expressed to apply for a limited time period of one year post termination;
- The restrictions only applied within a certain geographic area (the "Restricted Area"); and
- A severance clause had been incorporated, which included the following wording:

"It is... agreed that if any of the restrictions or provisions contained in this agreement shall taken together or separately be held to be void or ineffective for any reason but would be held to be valid and effective if part of the wording were deleted, or the period or area of application be reduced, that restriction shall apply with such deletions or with such reduced period or area of application as may be necessary to make it valid and effective."

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The franchisor admitted that the area covered by the non-compete clause was too wide and thus in restraint of trade and unenforceable. The franchisor proposed that the "blue pencil test" be applied and sought severance in respect of a portion of the Restricted Area definition applicable to the non-compete clause with a view to rendering it enforceable. The franchisees acknowledged that the non-compete clause would not be in restraint of trade if it was limited as proposed by the franchisor. Both parties agreed that the separate non-solicitation covenants contained in the franchise agreements were valid, despite the fact that they used the same definition of "Restricted Area".

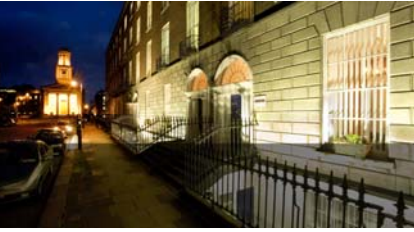
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In applying the "blue pencil test", the Judge refused to sever the offending part of the definition of Restricted Area for the unenforceable non-compete clause, finding that to do so would modify, or effectively re-write, what remained of the contract by cutting down a provision that was valid and enforceable (i.e. the non-solicitation clause).

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Conclusion

It remains to be seen if the *Francotyp-Postalia* judgment will be followed in Ireland. It is important that restrictive covenants be carefully drafted taking account of all of the circumstances paying particular attention to such matters as



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making sure that each restriction is identified as a separate independent provision, clearly defining the restricted business, restricted period and restricted area in accordance with requirements imposed by the doctrine against restraints of trade and competition law. What may be regarded as a reasonable delineation (whether in terms of time, scope of business or geography) for one restrictive covenant may be unreasonable for another. Using a defined term which applies to all of the restrictive covenants in a contract can deter a Court from applying a severance clause to vary the terms of a restrictive covenant as happened in *Francotyp-Postalia*. In *Francotyp-Postalia*, had the restricted area been stated separately, in full, in each sub-clause, the non-compete covenant might have survived.

For more information please contact



Marco Hickey is a partner in the Business Department and heads the EU, Competition and Regulated Markets Unit. Marco specialises in the field of EU, competition and regulated markets including merger control, the prohibition on restrictive agreements and practices, and abuse of a dominant position.

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