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NEW CHALLENGES FOR INTERNATIONAL FRANCHISING

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POST-TERM COVENANTS AND THEIR ENFORCEABILITY IN FOREIGN MARKETS

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Peter Buberis
KHQ Lawyers
Adelaide, South Australia, Australia

Karsten Metzlaff
Noerr LLP
Berlin, Germany

Tao Xu
DLA Piper LLP (US)
Washington, DC, USA

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1. Introduction

Franchisors usually impose a variety of obligations that arise from the termination of the franchise relationship, to protect the interests of the franchisor and the franchise system at large. This paper contains the examination of these post-term obligations in two legal systems – Australia (as a representative of the common law jurisdictions) and Germany (as a representative of the civil law jurisdictions).Our hope is that through these examinations, practitioners can glean some perspectives as to how these post-term covenants are dealt with under the laws of the foreign countries, which will help them draft these provisions that are better tailored to reflect the franchisors' actual business needs, and might stand a better chance of enforcement in these foreign jurisdictions.

2. Types of Post-Term Covenants

Covenants restricting a terminated franchisee from competing with its former franchised unit or other units in the franchise system, including restrictions on contacting former customers or clients of the franchised business, are common provisions in franchise agreements. Given the anti-competitive nature of these covenants, they also have probably the largest body of law dealing with the enforceability of such covenants. Other common restrictions that apply after the end of a franchise agreement include confidentiality obligations (imposed on the franchisee, its owners and key management personnel), and non-solicitation obligations (prohibiting a former franchisee from poaching the franchisor's and other franchisees' employees).

3. Legal Framework – Australia

3.1 Introduction

Australia is a common law country and for those similarly reliant it will, on its laws and their interpretation, seem a comfortable destination. For those who are underpinned by the civil law notions of reasonableness, implied good faith and objectivity provide crossing points.

The rationale for restrictions on a party's behaviour, both in term and post term, are well understood as are the tests against which relevant terms will be assessed. This section will provide an overview of the common law position in Australia and identify the relevant statutory overlays that may significantly impact on a franchise practitioner assisting a client in that jurisdiction.

It should be noted at the outset that a contractual choice of law involving the views and methodologies of a foreign country is likely to be upheld in Australia but not to the extent that the mandatory laws of Australia are overridden. One of those mandatory laws is the Franchising Code of Conduct, a federal law that mandates disclosure at the commencement of the relationship and on an ongoing basis, good faith, behavioural matters and dispute resolution. Further the format and requirements of the necessary disclosure document are mandated. There are no state franchise laws.

This section will look at the generic forms of competition restrictions on a separate basis as the concept of a restraint on ongoing trade, as opposed to non-solicitation or use of intellectual property, is treated differently as are the related obligations of ongoing confidentiality.

3.2 Non-Compete Clauses under Common Law

Let's start with the general law position absent any statutory change or overlay.

Australian common law draws its guidance and broad principles from English common law. In the field of post-term restraints, seminal decisions such as *Nordenfelt vs. Maxim Nordenfelt Guns and*

Ammunition Company[1] underpin the modern doctrine of restraint of trade, drawing as they do on still earlier determinations going back as far as the 18th Century.

We know from those cases and many that have followed[2] that one must:

- utilize clear and unambiguous drafting;
- determine the proper limits for a restraint and not exceed them. They must be linked to a legitimate purpose; and
- make reasonableness our measuring stick both in our dealings with the other party and in the interests of the public.

On nearly any analysis, whether at common law or under the legislation of a particular jurisdiction, the above principles may be all that is needed to predict the response of a court in assessing a "post-expiration/termination" restraint as not contrary to public policy and reasonable in the circumstances.

The care given to our drafting, so as to survive a judicial review in one set of circumstances, gains increased importance if the determination affects the entire franchise system. If one attempt at enforcement fails then steps may have to be taken to cause all extant agreements to be brought into line with the judicial assessment.

Another consideration is the breadth of the persons covered by contractual restraints. Were separate deeds of restraint secured for all associates of the franchisee? If not, are non-signatories capable of being bound?

Three general principles usually carried over to common law countries are:

- Non-competition clauses are, absent statutory exceptions, prima facie void as contrary to public policy. They need survive judicial review.
- There must be clear drafting, an assessment of reasonableness and satisfactory presentation of a case for the franchisor to establish that the inclusion of such clauses is necessary in its legitimate commercial interests and those of the public.
- Absent specific state law, an Australian court is not able to redraft or read down clauses that exceed the known parameters. There is no general right to blue-line clauses to bring them within tolerable application.

Because of the restraint on blue-lining, practitioners have quickly adapted their drafting to include "cascade or ladder" clauses that permit a variety of time limits and geographical areas to be combined by a court to achieve an outcome that is not contrary reasonableness between the parties and public policy.

Lurking behind this approach, is the reality that statutory instruments may negate the best drafting employed to achieve an enforceable post term restraint.

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1 [1894] ACC 535.

2 *Esso Petroleum V Harper's Garage (Stourport) Ltd* [1968] AC 269.

3.3 State Legislation

New South Wales is the most populous and economically significant state in Australia counting for some 33% of GDP. It is the only State jurisdiction to have enacted legislation dealing with restraint of trade clauses. This legislation reverses the first and third general principles described above.

These rules are contained in the *Restraints of Trade Act 1976*. Section 4 of the Act, in part, reads:

"*Extent to which restraint of trade is valid*

(1) *A restraint of trade is valid to the extent to which it is not against public policy, whether it is in severable terms or not.*

(2) *Subsection (1) does not affect the invalidity of a restraint of trade by reason of any matter other than public policy.*

(3) *Where, on application by a person subject to the restraint, it appears to the Supreme Court that a restraint of trade is, as regards its application to the applicant, against public policy to any extent by reason of, or partly by reason of, a manifest failure by a person who created or joined in creating the restraint to attempt to make the restraint a reasonable restraint, the Court, having regard to the circumstances in which the restraint was created, may, on such terms as the Court thinks fit, order that the restraint be, as regards its application to the applicant, altogether invalid or valid to such extent only (not exceeding the extent to which the restraint is not against public policy) as the Court thinks fit and any such order shall, notwithstanding sub-section (1), have effect on and from such date (not being a date earlier than the date on which the order was made) as is specified in the order*."

So, in NSW a restraint is not prima facie invalid. It is valid to the extent that it is not against public policy and to the extent the contract terms permit. [3]

Secondly, the court has discretion to "blue line" the terms of the relevant restraint where it goes beyond what is reasonable. "*The subsection permits the court to enforce a covenant whose provision is over extensive as regards area, time or extent."* See, *Woolworths Ltd vs. Olson*.[4]

Drafting Note

It may be useful to make franchise agreements subject to the laws of NSW as restraints are not prima facie invalid and the courts may use blue-lining in contrast to other Australian jurisdictions.

3.4 Applicability to Franchise Arrangements

As franchise practitioners, we must be mindful of any industry specific terms of the law in Australia and therefore the provisions of the Franchising Code of Conduct.

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[3] *Restraints of Trade Act 1976* (NSW) s 4(1).

[4] [2004] NSWSCA 372, 45.

The suitability of employing restraint terms in a franchise agreement has been accepted as a matter of principle.

The case that best articulates this is *KA & S Smith Pty Ltd vs. Ward*[5] and the words of Austin J:

> *"To assess the reasonableness of the restraint clause, it is necessary to identify the legitimate interests which the clause seeks to protect. This is not a case where the purchaser of a business seeks to protect goodwill which it has acquired by restraining the vendor from competing; nor is it a case where an employer seeks to protect its confidential information by restraining a former employee from working for a competitor. A Franchise agreement has some of the elements of both of these cases, although it is a commercial arrangement closer to the former than the latter: Prontaprint Plc vs. Landon Litho Ltd*[6]*; Stokely-Van Camp Inc vs. New Generation Beverages Pty Ltd*[7]*. In my opinion the franchisor has a stake which is analogous to the purchaser's goodwill. It has an interest in protecting the patronage built up through the operation of the franchise, which may be lost if the franchisee is permitted to compete without restriction. The franchisor also has an interest in protecting the confidentiality of confidential information provided to the franchisee, which could be used by the franchisee to compete with the franchisor if there was no restraint. However, the franchisee has an interest in protecting the goodwill of its business. The customers are customers of the franchisees business, though the franchisor also has an "interest" in the customers since they are attracted to the business as a franchise business. The question is whether the restraint clause in the second franchise agreement is too wide, given the nature of the franchisor's interest and the need to balance the interests of franchisor and franchisee."*

3.5 Franchising Code of Conduct - Clause 23

The latest iteration of the Code, that came into effect on 1st January 2015, has injected an overlay to the accepted application of the accepted common law where a franchise relationship exists. This statutory commentary puts to one side a comfortable assessment of what is needed to draft and enforce a clause on the subject of post-term restraints.

The Code has, in recognising the underpinning rationale for the entering into of the franchise relationship, added an incentive for the franchisor to take an early and long view of the franchise relationship and whether it would ever want to invoke a post-term restraint.

In the 2014 Code a new clause 23 was introduced applicable to franchise agreements entered into or renewed after 1st January 2015. This clause begins:

"*Effect of restraint of trade clause if franchise agreement not extended*

(1) *A restraint of trade clause in a franchise agreement has no effect after the agreement expires if:*

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5 (1998) 45 NSWLR, 402.

6 [1987] FSR 315, 324.

7 (1998) 44 NSWLR 607, 613.

(a) *the franchisee had given written notice to the franchisor seeking to extend the agreement on substantially the same terms as those:*

(i) *contained in the franchisor's current franchise agreement; and*

(ii) *that apply to other franchisees or would apply to a prospective franchisee; and*

(b) *the franchisee was not in breach of the agreement or any related agreement; and*

(c) *the franchisee had the term of the agreement; and not infringed the intellectual property of, or a confidentiality agreement with, the franchisor during the term of the agreement; and*

(d) *the franchisor does not extend the agreement; and*

(e) *either:*

(i) *the franchisee claimed compensation for goodwill because the agreement was not extended, but the compensation given was merely a nominal amount and did not provide genuine compensation for goodwill; or*

(ii) *the agreement did not allow the franchisee to claim compensation for goodwill in the event that it was not extended.*

(2) *Subclause (1) also applies in respect of a restraint of trade clause that is incorporated into a franchise agreement:*

(a) *by reference to another document; or*

(b) *by another document physically attached to the agreement.*

Note See subclauses 3(4) and (5)."

Preceding the introduction of Clause 23 an Explanatory Statement was released by the parliamentary draughtsman. This Statement made it clear that the new inclusion in the Code seeks some middle ground. It is not as, pervasive as it may first sound and focuses on competition restraints only. It does not apply to non-solicitation, restraints on hiring employees, confidentiality or other restraints.

The Explanatory Statement makes the following observations:

(1) *"The clause only applies to restraint of trade clauses designed to prevent competition by a former franchisee. It does not apply to other restraint clauses, such as those that prevent a former franchisee approaching staff of the franchisor or using the franchisor's intellectual property.";*

(2) *".. paragraph 23(1)(a) is intended to ensure that the franchisor cannot offer the franchisee a substantially different agreement to that offered to other franchisees or prospective franchisees";*

(3) *"... compensation does not include compensation for goods returned or a rebate of moneys paid by the franchisee.";*

(4) *"where it can be shown that the former franchisee has contributed to the growth of the franchised business and has thereby generated goodwill in the franchised business, it is considered reasonable that the former franchisee be compensated for that, if it is to be limited by a restraint of trade clause. Whether the compensation offered is genuine should be decided having regard to the circumstances of the case";*

(5) *"the provision does not prevent the franchisor taking action where it believes a former franchisee has breached a restraint of trade clause. The onus will be on the former franchisee to show it comes within the exception contained in clause 23."*

It should be noted that there are other jurisdictions outside Australia where there is mandated compensation or a goodwill payment on the ending of a distribution/licencing agreement and in that context the new Australian approach is not uniquely shocking to a franchisor.

Drafting Note

It is recommended that in drafting franchise agreements a general provision is included that, should clause 23 apply, the parties will in good faith discuss compensation upon the expiry of the Franchise Agreement term. This obviates sub-clause (1)(e)(ii) as a qualifying factor for the application of clause 23 and simplifies any argument that it does not apply.

3.6 The Disclosure Document (Annexure 1 Item 18)

This mandated item of the disclosure document deals with the need to give the franchisee notification of the franchisor's extension intentions at the end of term.

If the terms of restraint clauses are regarded as a critical component in maintaining the integrity of a system then appropriate drafting indicating the franchisors views on each of the components of clause 23 is needed. If it has no desire to permit a conditional extension then it must make this plain in bold characters and ensure the drafting of the franchise agreement is well thought out to at least provide that a conditional compensation formula built into it.

3.7 Confidentiality Terms

So, the above demonstrates that post term non-compete restraints are treated differently under Australian law. In part this is because at common law in term restraints and post term restraints cannot be compared on an equal basis given what may be reasonable in term will differ from what is reasonable post term. Further a specific statutory provision like Clause 23 of the Code may limit the applicability of post term competition even if the relevant restraint is otherwise satisfactorily drafted. Non-competes differ from "non-solicitation" and "no intellectual property use" restraints as clause 23 makes clear.

Confidentiality as a covenant is assessed as a type of post term restraint however given its exclusion from Clause 23 of the Code it is much more dependent on the stated principles of the common law. The Franchising Code has nothing to say on the point and confidentiality remains the province of proper definition and appropriate contractual terms.

The three recognised criteria for recognising and enforcing an obligation of confidentiality are:

- The information has the necessary quality of confidence;
- The information is imparted in circumstances importing an obligation of confidence; and
- There is unauthorised use or disclosure of the information.

Further the restraint must be assessed as reasonable, including as to the time over which the restraint may be maintained.

The time imposed for the restraint to apply is a clear drafting issue if Australian law applies given the views put by the High Court of Australia in the case of *Maggbury Pty Ltd vs Hafele Australia Pty Ltd*.[8] In that case a perpetual confidentiality contractual term was rejected as unreasonable. The court held that if confidential information has entered the public domain through no action on the part of the party bound by the restraint then it will no longer be bound by the obligation. If the restraint is expressed to be for an excessive period this would not be considered as reasonable. The court in fact suggested a period not exceeding 5 years may be appropriate.

Taking a cue from this, 5 years is now commonly used by Australian lawyers to time limit confidentiality periods.

Absent specific statutory terms in State or Commonwealth Law such as Government security, Personal Privacy and so forth, the application of general common law principles to the franchise relationship make the matter of reasonableness as to time constraints an important local issue. Foreign practitioners caught in these circumstances may of course consider the scope for a choice of laws clause using another jurisdiction on the matter of enforcement.

3.8 Unfair Contract Terms

An issue now prominent in Australia is the application to the franchise relationship of Unfair Contract terms. This law is stated in Pts 2-3 of the Australian Consumer Law.

It is a law that provides a regime for rendering void unfair contract terms in standard form "small business" contracts. These are businesses with turnover of less than $1,000,000 AUD or less than 20 employees. There is now a level of certainty that the Unfair Contract Law does apply to franchise agreements which many regard as having the prima facie appearance of standard contracts.

The opinion of local counsel as to how this might apply to post term restraint clauses should be sought. A matter reinforced by the opinion of the Regulator (the Australian Consumer and Competition Commission) that non-compete clauses should be reviewed for reasonableness/fairness in the context of small businesses.

3.9 Enforcement

The enforcement of restraints suffers uncertainty, whether under common law or through the stated statutory intervention. This is the case whether you are the franchisor or franchisee.

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8 [2001] HCA 70; (2001) 210 CLR 181.

The franchisor needs to accept that under common law, restraints are prima facie invalid if approached under established principles. It must satisfy the tests that consider the reasonableness of the drafting in the circumstances of the parties and with regard to the public generally.

While the franchisee has the advantage that the burden of satisfying these matters lies with the franchisor, it can rarely feel confident of the outcome and is required to expend resources to test the applicability of contractual terms.

The careful drafting of ladder or cascade clauses opening up permitted blue lining can lessen some of that uncertainty, but even reliance on that may not be enough.

At this time little may be drawn by a franchisee out of the Code to suggest the hurdles of compliance that it needs to climb will be interpreted generously giving it a satisfactory outcome on compensation or non-applicability of the restraint on agreement expiry.

Franchisors may presently feel that Clause 23 is of little consequence and that an assessment of the general law tests is the main hurdle to overcome. This may change if the courts adopt a generous assessment, favoring franchisees, on the necessary pre-conditions but for the moment some minor redrafting to ensure that compensation on expiry is not wholly excluded could suffice.

Commentary by the courts in Australia on contractual restrictions under the general law can be found in the following cases:

- *Amoco Australia Pty Ltd vs Rocca Bros Motor Engineering Co Pty Ltd*[9] where the court found that the doctrine of unlawful restraint of trade applied to covenants given by someone starting a new business in relation to future trading.

- *Queensland Co-operative Milling Association vs Pamag Pty Ltd*[10] which affirmed that a restraint covenant was subject to the test of reasonableness.

- *Emeco International Pty Ltd vs O'Shea [No.2]*[11] where the assessment of commercial parties' activities was held to have relevance given they contract by reference to their own commercial interests.

- *Ausdale Enterprises Pty Ltd As trustee for The Lovett Family Trust vs Sandford*[12] where it was found that commercial assessments and interests are relevant when forming a judgement about what is reasonable. The reasonableness of the restraint turns on its own facts.

Other useful authorities include;

- *Murray Pest Management Pty Ltd vs A & J Bilske Pty Ltd*[13]

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9 (1973) 1 ALR 385.

10 (1973) 133 CLR 260.

11 (2012) WASC 348.

12 2006] WASCA 191.

13 [2012] NTSC 5 (n 7).

- *BB Australia Pty Ltd vs Kariori Pty Ltd*[14]
- *Little Images Pty Ltd vs Fresh View Venture Pty Ltd& Anors*[15]
- *Raine & Horne Pty Ltd vs Adacol Pty Ltd*[16]
- *Bodycorp Repairers vs Maisono*[17]

4. Germany

4.1 EU Competition Law

Within the EU, two sets of competition laws apply: EU competition law and the national competition law of each Member State. Article 101 of the Treaty on the Functioning of the European Union (TFEU) is the primary source of European competition law as to cartels. Article 101 of the TFEU is binding and directly applicable in all member states of the EU. Article 101 of the TFEU prohibits agreements and other concerted practices, which have as their object or effect the prevention, restriction or distortion of competition.

a. *Art. 101(1) of the TFEU*

Article 101(1) of the TFEU affects all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between EU member states and which have as their object or effect the prevention, restriction or distortion of competition within the internal. Article 101(1) of the TFEU seeks to ensure that undertakings independently determine their business's policy on the Internal Market.[18]

In 2014 the Commission has published a "De Minimis" Notice[19] setting out the circumstances in which agreements will not be viewed as infringing Article 101(1) TFEU – that is, where the market shares of the franchisor and franchisee are each 15% or less, provided that the agreement contains no restrictions of competition by object. Restrictions by object are those agreements, that have, by their very nature, a high potential for negative effects on competition[20](= 'hard-core' restrictions, which are mainly pricing, territorial and resale restrictions). For example, with regard to franchise agreements, minimum resale price fixing constitutes one of the typical restrictions by object.

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14 [2010] NSWCA 347 (n 8).

15 [2011] QSC 402.

16 [2006] NSWC 36.

17 [2017] VSCA 252.

18 Case 40/71, Suiker Unie, 1975 E.C.R. 1664 at para 174 (E.C.J.).

19 Commission Notice on agreements of minor importance which do not appreciably restrict competition under Article 101(1) of the Treaty on The Functioning of the European Union (De Minimis Notice), OJ No. C 291/1 of 30 August 2014.

20 See Guidance on restrictions of competition „by object" for the purpose of defining which agreements may benefit from the De Minimis Notice, SWD (2014), 198 final of 25 June 2014.

Agreements or decisions taken in violation of Article 101(1) of the TFEU shall be automatically void (Article 101(2) of the TFEU).

b. *Pronuptia and Vertical Restraints Block Exemption Regulations*

The European Court of Justice (E.C.J.) has held in its landmark case *Pronuptia* that provisions, which are essential for the functioning of a franchise system do not constitute restrictions on competition for the purposes of Article 101(1) of the TFEU.[21] It considers two categories of provisions essential for the functioning of a system:

- Firstly, those provisions, which ensure that a franchisor can communicate know-how and provide assistance without running the risk that said know-how or assistance benefits competitors.[22]

- Secondly, measures taken by the franchisor which are necessary to maintain the identity and reputation of the network, shall not constitute restrictions of competition for the purposes of Article 101(1) of the TFEU.[23]

Provisions essential to secure that know-how does not benefit competitors are in particular non-compete clauses and provisions requiring the franchisors' consent prior to the transfer of the franchisee's undertaking to a third party.[24]

Essential provisions with regard to maintaining the identity and reputation of a franchise system are the franchisee's obligation to use the know-how provided and business method developed by the franchisor as well as restrictions imposed on the location and design of the franchisee's store.[25] The E.C.J. also deems clauses which ensure the franchisors' right to freely choose the franchisees to be necessary to maintain the reputation of the franchise system.[26] Clauses prohibiting the franchisees to source from other suppliers and limiting their advertising opportunities may be essential in certain cases as well.[27]

In *Pronuptia*, the ECJ recognized that clauses that prevent the franchisee from competing with the franchisor or other members of the franchised network for the duration of the franchise agreement and for a reasonable period after termination are essential for protecting the franchisor's know-how. Decisions of the ECJ take precedence over any views expressed by the European Commission, whether in a block exemption or in other documents.

c. *Vertical Agreements Block Exemption Regulation (VA-BER)*

If a franchise agreement falls within the scope of Article 101(1) of the TFEU, it may still comply with competition law. When assessing franchise agreements special consideration has to be given to the

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21 Case 161/84, Pronuptia v. Schillgalis, 1986 E.C.R. 374 para 16-27 (E.C.J.).

22 *Pronuptia*, *supra* note 4, para 16.

23 *Pronuptia*, *supra* note 4, para 17.

24 *Pronuptia*, *supra* note 4, para 16.

25 *Pronuptia*, *supra* note 4, para 18-19.

26 *Pronuptia*, *supra* note 4, para 20.

27 *Pronuptia*, *supra* note 4, para 21-22.

Vertical Agreements Block Exemption Regulation (VA-BER).[28] The VA-BER is applicable to different types of vertical agreements such as agency, selective distribution, franchise and exclusive distribution. Vertical agreements are exempt[29] from the prohibition of Article 101(1) of the TFEU, if the market shares of the parties to the agreement do not exceed 30%[30] and if the agreement does not contain any hardcore-restrictions.[31] The VA-BER thus creates a "safe harbor" for all agreements within its scope.[32]

Vertical Agreement is defined as "an agreement or concerted practice entered into between two or more undertakings each of which operates, for the purposes of the agreement or the concerted practice, at a different level of the production or distribution chain, and relating to the conditions under which the parties may purchase, sell or resell certain goods or services" (Article 1(1) VA-BER). Different types of franchise agreements – especially commercial and distribution agreements – may benefit from the VA-BER. Industrial franchise agreements however do not necessarily qualify for the exemption.[33]

The European Commission has listed certain obligations in its Guidelines on Vertical Restraints which it deems necessary to protect the franchisor's intellectual property rights and which therefore fall under the block exemption.[34] These are:

(a) an obligation on the franchisee not to engage, directly or indirectly, in any similar business;

(b) an obligation on the franchisee not to acquire financial interests in the capital of a competing undertaking such as would give the franchisee the power to influence the economic conduct of such undertaking;

(c) an obligation on the franchisee not to disclose to third parties the know-how provided by the franchisor as long as this know-how is not in the public domain;

(d) an obligation on the franchisee to communicate to the franchisor any experience gained in exploiting the franchise and to grant the franchisor, and other franchisees, a non-exclusive license for the know-how resulting from that experience;

(e) an obligation on the franchisee to inform the franchisor of infringements of licensed intellectual property rights, to take legal action against infringers or to assist the franchisor in any legal actions against infringers;

(f) an obligation on the franchisee not to use know-how licensed by the franchisor for purposes other than the exploitation of the franchise;

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28 Commission Regulation 330/2010, 2010 O.J. (L 102) 1.

29 Article 2(1) VA-BER.

30 Article 3(1) VA-BER.

31 Article 4 VA-BER; note that a hard core restriction leads to the nullification of the entire franchise agreement, see COMMISSION NOTICE: GUIDELINES ON VERTICAL RESTRAINTS, 2010 O.J. (C 130) 1, para 70.

32 VERTICAL GUIDELINES *supra* note 15, para 23.

33 *Id*. at para 45; FRANCK WIJCKMANS & FILIP TUYTSCHAEVER, VERTICAL AGREEMENTS IN EU COMPETITION LAW, (2d ed. 2011), para 6.75.

34 VERTICAL GUIDELINES *supra* note 15, at para 45.

(g) an obligation on the franchisee not to assign the rights and obligations under the franchise agreement without the franchisor's consent.[35]

d. *Art. 101(3) of the TFEU*

A franchise agreement does not fall within the scope of the VA-BER if the market shares of the parties to the agreement do exceed 30%, the agreement does contain hardcore-restrictions, and/or specific requirements of Article 5 VA-BER for the block exemption of a particular clause are not met.

If the VA-BER is not applicable the undertaking has to assess whether the requirements of Article 101(3) of the TFEU are satisfied on an individual basis. Article 101(3) of the TFEU in conjunction with Article 1(2) Regulation 1/2003 provides an opportunity for individual exemption from the prohibition of Article 101(1) of the TFEU if the following four requirements are fulfilled:

(a) the agreement must contribute to the improvement of the production or distribution of goods or to promoting technical or economic progress,

(b) while allowing consumers a fair share of the resulting benefit, and

(c) which does not impose on the undertakings concerned restrictions which are not indispensable to the attainment of these objectives;

(d) afford such undertakings the possibility of eliminating competition in respect of a substantial part of the products in question.

It is the undertaking's duty to self-assess if its conduct meets either the requirements of a VA-BER or of Article 101(3) of the TFEU. A prior decision by the Commission to that effect is not required (Article 1(2) Regulation 1/2003).

e. *Applicable Test Set-Up*

Compliance with European Union Competition law thus needs to be assessed in the following steps:

- Does the franchise agreement restrict competition according to of Article 101(1) of the TFEU or does PRONUPTIA apply?
- If so, does the franchise agreement fall within the scope of the VA-BER? or Article 101(3) of the TFEU itself?
- If not, is it exempted from the prohibition of Article 101(1) of the TFEU, because it fulfills the criteria of Article 101(3) of the TFEU?

The burden of proof that the agreement restricts competition (step 1) is upon the party claiming that the franchise agreement violates Article 101(1) of the TFEU, whereas the burden of proof for the claim that the criteria of a VA-BER or Article 101(3) (step 2) are fulfilled lies with the party claiming that the agreement is valid.

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[35] VERTICAL GUIDELINES *supra* note 15, at para 45 (a) – (g).

4.2 German and Other EU National Laws

EU competition law is directly applicable in all member states of the European Union if an agreement affects trade between EU member states. The applicability is neither conditioned upon the adoption of these provisions into national laws nor upon a prior decision by a competition authority (Articles 1 and 3(1) Regulation 1/2003). National Competition Authorities, therefore, can directly apply EU competition law.

German competition law is regulated mainly by the Act against Restraints of Competition (ARC). In 2005, German competition law was completely harmonized with European competition law. All forms of competition restraints contained in distribution agreements, such as non-compete clauses, non-solicitation clauses, non-dealing clauses and confidentiality covenants, are now treated in full compliance with European competition law. The same is true for other national competition laws of EU member states.

Article 3(2) Regulation 1/2003 prevents the application of national competition laws in cases in which it would lead to the prohibition of agreements, which may affect trade between Member States but do not violate Article 101 of the TFEU, either because they do not restrict competition or because they are exempt from Article 101(1) of the TFEU as they fulfill the conditions of Article 101(3) of the TFEU. Article 101 thus takes precedence over national competition laws, if the agreement may affect trade within the EU. Trade is not limited to the exchange of goods and services but also encompasses agreements which merely affect the competitive structure of the market.[36] It may be affected, if a sufficient degree of probability leads to the assumption of an appreciable influence on the pattern of trade between member states.[37] The capability to affect trade is sufficient.[38] The E.C.J. has therefore held that franchise agreements which allocate markets are "in any event liable to affect trade between Member States, even if they are entered into by undertakings established in the same Member State, in so far as they prevent franchisees from establishing themselves in another Member State."[39]

If franchise agreements may affect trade within the EU, it is therefore only necessary to evaluate, if the franchise agreements comply with the requirements laid down in Article 101 of the TFEU. An assessment according to national competition laws is only necessary, if the franchise agreement may not affect trade between Member States.

4.3 Post-Term Covenants

a. *Non-Competition*

Franchise systems have a respectively privileged position regarding the prohibition of competition during the contractual period and thereafter (non-competition clauses) [40]. The E.C.J. deems non-

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[36] COMMISSION NOTICE: GUIDELINES ON THE EFFECT OF TRADE CONCEPT CONTAINED IN ARTICLES 81 AND 82 OF THE TREATY, 2004 O.J. (C 101)81 at para 19-20.

[37] *See further Id.* at para 19-57.

[38] *Id.* at para 26.

[39] *Pronuptia*, *supra* note 4, para 26.

[40] Pursuant to Article 1(d) VA-BER "'non-compete obligation' means any direct or indirect obligation causing the buyer not to manufacture, purchase, sell or resell goods or services which compete with the contract goods or services, or any direct or indirect obligation on the buyer to purchase from the supplier or from another undertaking designated by the supplier more than 80% of the buyer's total purchases of the contract goods or

competition clauses in franchise agreements essential to protect the know-how of the franchisor. It has therefore held that these clauses do not infringe Article 101(1) of the TFEU, if they are limited to the period of validity of the agreement or for a reasonable period after its expiry.[41]

The Commission states that in-term non-compete obligations may be necessary to maintain the common identity and reputation of the franchised network. An in-term non-compete restraints shall therefore usually fall outside the scope of Article 101(1) of the TFEU as long as it does not exceed the duration of the franchise agreement itself.[42] However, Article 5 VA-BER, if applicable, generally limits the duration of in-term non-compete restraints to five years.

Under competition law, post-term non-compete clauses may fall under the ban on cartels (article 101(1) TFEU) if they have an appreciable impact on competition. Those post-term non-compete clauses are generally not exempted by the VA-BER. Nevertheless, Article 5(3) VA-BER allows post-termination non-competition clauses if the following four criteria are met:

(a) the obligation relates to goods or services which compete with the contract goods or services;

(b) the obligation is limited to the business location from which the franchisee has operated during the contract period;

(c) the obligation is indispensable to protect know-how transferred by the franchisor to the franchisee; and

(d) the duration of the obligation is limited to a period of one year after termination of the agreement.

For mobile or services franchises, post-term non-compete covenants that apply only in respect of the franchisees premises may afford little protection due to the fact that the franchisee can change the location of his business. In such circumstances franchisors may seek to rely on the ECJ's decision in *Pronuptia* to justify more far-reaching restrictions.

Please note that agency law is applied to franchise agreements. As a result, the franchisee enjoys similar protection to a commercial agent. This has an important consequence: the franchisee is entitled to payment of reasonable remuneration if the franchisee agrees not to compete with the franchisor after termination of the franchise agreement. The appropriateness of the compensation is being determined on the basis of the prospective loss the franchisee will suffer because of the post-term non-compete clause. The possibility of entering a profession that's not affected by the non-competition clause is also considered.

b. ***Non-solicitation***

In Europe, solicitation bans have so far only been regarded as a side issue, at least in terms of antitrust law. However, such non-solicitation clauses between companies have not been the subject of independent EU antitrust proceedings, but only in connection with company transactions. In EU antitrust proceedings, the European Commission has occasionally been informed of employee antitrust bans in

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services and their substitutes on the relevant market, calculated on the basis of the value or, where such is standard industry practice, the volume of its purchases in the preceding calendar year."

41 *Pronuptia*, *supra* note 4, at para 25.

42 VERTICAL GUIDELINES *supra* note 15, at para 190(b).

addition to a number of other cartel violations; however, the European Commission has not yet issued an independent decision on antitrust bans or even imposed a fine for them. Most national European antitrust authorities have also not explicitly dealt with the treatment of non-solicitation clauses or have only dealt with them in the context of company transactions and have based their decision on the European Commission's Notice regarding restrictions directly and necessary to concentrations.[43]

c. *Confidentiality*

As already mentioned, restrictions necessary either to protect the franchisor's know-how or to maintain the identity and reputation of the franchise, do not fall within Article 101(1) TFEU (see above). Another example is an obligation on the franchisee to keep secret know-how strictly confidential. Such an obligation may also include a reasonable period after the ending of the agreement. It can even contain the duty to pass on this obligation to employees. Article 101(1) does also not apply to obligations on the franchisee to inform the franchisor if someone infringes his intellectual property rights, to assist him in legal actions or even to take legal actions by himself. That is also the case with regard to obligations on the franchisee to use the promotion material supplied by the franchisor. He may also be bound by contract to share the experience gained in exploiting the franchise and to grant the franchisor and other franchisees license for the resulting know-how.

Thus, after the term of the agreement the franchisee can be prohibited from using and disclosing know-how provided by the franchisor that has not entered the public domain.

If the know-how has not entered the public domain, the use and disclosure of that know-how can be prohibited without a time limit. Even though the text of the VA-BER does not expressly mention franchise agreements and its applicability is not limited to them, they are the most likely distribution systems to benefit from the exemption.[44]

4.4 Enforcement

a. *Enforcement of Competition Law in General*

In the EU national competition authorities and courts are empowered to apply and enforce Article 101 of the TFEU. The Commission and the national competition authorities with concurrent competition powers have significant powers to investigate suspected anti-competitive behavior (including entering and searching business and private premises with a warrant. The most important cartel authorities in Germany are the Federal Cartel Office (FCO) and the EU Commission. Public enforcement of antitrust law is mostly ensured by the imposition of sanctions (such as fines) as well as cease-and-desist orders. A company engaged in activities which breach of these provisions can face fines of up to 10% of its group global turnover.

European competition law is not only enforced by public authorities but also by private parties. Over the last two decades, private enforcement became more and more important in the EU. In order to promote this development and to facilitate private enforcement, the European Parliament issued a directive

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[43] Commission Notice 2005 O.J. (C 56) 03.

[44] *See also* GOYDER *supra* note 19, at 195 and WIJCKMANS & TUYTSCHAEVER, *supra* note 17, at para 6.95.

on antitrust damages actions.[45] The directive was incorporated into German law by the 9th Amendment to the ARC.

Provisions in agreements which infringe Article 101 TFEU are void and unenforceable (which may lead to the entire agreement being unenforceable). A further key deterrent for businesses is the major disruption and damage to a company's reputation which arise from lengthy investigations or subsequent litigation from customers, franchisees, competitors and consumers.

Even if there is no difference in practical results between exempted agreements and agreements falling outside article 101(1) TFEU, the burden of proving that all conditions of an exemption are met rests with the party claiming its benefit. This can be essential if the question arises whether an agreement falling outside the VA-BER is valid or not.

b. *Standard Contract Terms Law*

As well as the offer and sale of franchises, the ongoing relationship between franchisor and franchisee is in Germany– apart from competition and antitrust law - governed by the general provisions of the Civil Code and the Commercial Code. In practice, the laws of the Civil Code concerning standard business conditions play an important role for the enforcement of standardized business conditions such as provisions in franchise agreements. This law (in particular, section 307 of the Civil Code) provides that standard terms are null and void if they unduly prejudice the other party contrary to the requirements of good faith. In other words, the standard terms law addresses unfair contract terms that operate unreasonably to the detriment of the other party. This has been closely observed when it comes to drafting the individual clause.

c. *Non-Competition*

If a franchisee does not comply with its obligation to comply with the non-compete covenants, the franchisor may apply for an injunction and claim damages from the franchisee. In addition, to secure confidentiality it is possible to agree on a contractual penalty. However, in order to be enforceable the clause must be carefully drafted by following the requirements as set out by Article 5(3) VA-BER.

It should also be noted that a post-term non-competition clause, which does not fall within the scope of the block examination does not lead to the nullification of the complete franchise agreement. The nullification is instead limited to the provision itself.[46] Other provisions in the franchise agreement are not affected and can be enforced.

d. *Confidentiality*

If a franchisee does not comply with its obligation to keep know-how, business or trade secrets confidential, the franchisor may apply for an injunction and claim damages from the franchisee. However, confidentiality covenants deem to be only enforceable if the franchisor can prove the existence of know-how which has been harmed by the franchisee.

Although know-how is part of a franchisor's intellectual property rights, the protection of know-how is not subject to specific statutes such as the Trademark Act or the Copyright Act. As a result there is

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[45] Directive 2014/104/EU of the European Parliament and of the Council on certain rules governing actions for damages under national law for infringements of the competition law provisions of the Member States and the European Union.

[46] *See* Article 5 VA-BER and VERTICAL GUIDELINES *supra* note 15, at para 65 and 71.

no registration requirement for licensing know-how. Even so, franchisors' know-how is confidential information under the franchise agreement or other confidentiality agreements. Breach of business confidentiality constitutes a breach of those agreements and, moreover, is punishable under the German Act Against Unfair Competition.

If the know-how has entered the public domain, the use and disclosure of that know-how can no longer be prohibited.

5. Conclusion

As demonstrated above, the enforceability of post-term covenants, in particular, the non-competition restrictions that apply after the end of the franchise agreement, is very much a creature of particular laws of each jurisdiction. In Australia, common law underpins the general principles that will apply to all of these covenants. Those principles then, in some cases, get readjusted by certain general legislations (e.g., in New South Wales, where there is a presumption of enforceability to the extent it is not against public policy), and in other cases, by franchise-specific laws and regulations (e.g., the regulation of the post-term non-compete covenants in Australia's Franchising Code of Conduct). Germany (and by extension, the entire EU block, with regard to the non-compete covenants), on the other hand, definitely approaches these issues from a legislative and regulative rule-making perspective, by setting up an intricate framework consisting of Article 101(1) of TFEU, Article 101(3) of TFEU, Vertical Agreements Block Exemption Regulation, and the possibility of additional national law applicable to franchise agreements not affecting trade between EU Member States. It is, however, worth noting that another major pillar of the legal regime surrounding the non-compete covenants in Germany (and the EU at large) is the *Pronuptia* case decided by the European Court of Justice more than 30 years ago.

The lesson is, as always, that the devils are in the details. To prepare a well-drafted package of post-term covenant provisions and to seek their enforcement in a foreign jurisdiction, it is essential to consult local lawyers well versed in these issues.

Biography of the Authors

Peter Buberis heads up KHQ's franchise and commercial teams. He has extensive experience acting for both national and international franchise systems with a strong skill set around the expansion of franchise systems. Peter lectures in international franchising at the Masters level at Australian universities and is an international speaker at legal forums and a published commentator in his area of expertise.

Karsten Metzlaff is a partner of the law firm Noerr LLP (www.noerr.com). He has, over the years, advised on the structure of a number of well-known national and international franchising systems and the expansion of those systems nationally and internationally. He also worked with the EU Commission in Brussels at the Directorate General for Competition where he dealt with franchising matters. Karsten Metzlaff is a member of the IBA, the ABA and the German Franchise Association. He has lectured and written on many various domestic and international issues of franchising and distribution law. He studied law at the Universities of Münster, Hamburg, Lausanne (CH) and London (GB). Karsten Metzlaff has been selected for inclusion in *The International Who's is Who of Business Lawyers, Franchise* (2019). In the latest JUVE edition (2018/2019) on German law firms, he has been named as one of leading attorneys in Germany in the field of distribution and franchising law. He has also been selected by BEST LAWYERS as leading franchise lawyer in Germany. He is the exclusive contributor to the *International Law Office Newsletter* for franchising in Germany (*www.InternationalLawOffice.com*).

Tao Xu devotes his practice to franchising and distribution matters, especially international franchising, licensing and distribution transactions. Tao counsels a broad range of clients in their international expansions, including master franchising, multi-unit licensing, area development, single-unit licensing and direct investment (both joint venture and wholly owned). Tao is particularly active in food and beverage, hospitality and leisure, and retail industries, having acted for a number of high profile US brands in their international expansion efforts. Tao is deeply involved in franchising activities in China, having both acted for a number of clients in entering the Chinese market and lobbied on behalf of the International Franchise Association in connection with the Chinese government's franchise regulations and their implementation rules.