

RESTRAINT OF TRADE CLAUSES IN BUSINESS SALE CONTRACTS

1. INTRODUCTION

Business sale contracts commonly include a restraint of trade – namely a clause that aims to prevent the seller of the business from competing after the purchaser takes over control of the business.

At law, it is considered in the public interest that restraints of trade are void except to the extent they reasonably protect legitimate business interests.

This results in a test which has two parts:

- (a) What is the buyer's interest to protect?
- (b) Is the restraint worded such that it covers what is reasonably necessary to protect those interests?

By its very nature, restraints protecting the purchase of a business can reasonably be for a longer period than restraints against employees.

2. LEGITIMATE BUSINESS INTERESTS TO PROTECT

When buying a business, it can be expected that the buyer has an interest in protecting the goodwill of the business being purchased. It would not be fair for the seller to receive value for the sale and then commence business in competition.

However, the detail of what is reasonably necessary to protect can vary from business to business.

The employer must be able to identify a particular business interest that it legitimately seeks to protect. It is not enough to simply seek to stop the prior business owner from establishing another business.

Generally, the following business interests have been identified by courts:

- The right to trade free from competition from the Seller

This right is inherent in the nature of the business sale.

- Confidential information

This relates to information that by its nature is confidential, such as customer lists and contact details, pricing schedules, and detailed product information.

- Customer connections

Clauses to protect the Buyer's new customer base usually seek to prohibit solicitation – namely approaches by the Seller seeking to entice the customer to change supplier.

- Poaching of staff

A Buyer clearly has an interest in maintaining a stable workforce. Accordingly, most restraint clauses seek to prohibit solicitation of staff.

Once a business interest has been identified and is considered capable of being protected, it is necessary to consider what is reasonably necessary to protect this interest.

3. IS THE RESTRAINT REASONABLY NECESSARY TO PROTECT THOSE INTERESTS?

The restraint must be reasonable in all circumstances.

In relation to prohibiting trading in competition this usually covers:

- Geographic area. As to what area is reasonably necessary to protect depends upon the nature of the business. For example a business that only trades in south-east Queensland might not need protection throughout all of Queensland.
- Time period of restraint. A reasonable time is that amount of time which it is expected it would take to create new business relations with the clients. That is usually likely to be 3 years, however could be different periods of time depending upon the nature of the business.

4. WHAT IF THE RESTRAINT IS TOO WIDE?

As the starting point is that a restraint that is wider than reasonably necessary is void, the consequence of a restraint clause which is drafted too widely is that it is void.

Often drafters fall into the trap of drafting a very wide provision seeking to protect the employer's interest. However, overreaching can mean destroying any chance of protection.

For example:

- If the business only trades in South-East Queensland, there is no business interest to protect outside that area.
- If supply to customers occurs monthly, there might be no need to prevent from competition for 12 months. If however, contracts are annual, then 3 years might be reasonable.

5. CASCADING CLAUSES AND SEVERENCE

It is now common for restraints to be drafted with cascading provisions, such as:

- The restraint is for 3 years;
- If that is void, then it is for 2 years;
- If that is void, for 1 year.

Cascading clauses in relation to geography are commonly worded in this manner:

- The restraint covers all of Australia;
- If that is void, then all of Queensland;
- If that is void, then South-East Queensland;
- If that is void, then Brisbane.

There is commonly a clause which provides that any part of the restraint which is considered void can be severed, and the remaining clause stands as valid.

This type of clause has been held by courts to be valid, and as a consequence, now commonly appears in restraints. The result of this however, is that the contract is not clear as to what in truth is the restraint which is objectively reasonable.

6. COMMENT REGARDING NSW LAW

In New South Wales, the *Restraints of Trade Act 1976* (NSW), allows the court to ignore the fact that a restraint goes beyond what is reasonable, provided the restraint can be enforced to the extent that is reasonable.

This is not the law in Queensland.

7. ENFORCING THE RESTRAINT

A purchaser of a business seeking to enforce a restraint must act without delay and seek an injunction (on an interim basis, known as an interlocutory injunction) to restrain the other party. Otherwise, delay may result in attempts to enforce the restraint having become redundant.

In order to obtain an interlocutory injunction, the employer must establish a serious question to be tried (that is, demonstrate to that the court will likely to find that the restraint is reasonably necessary to protect the legitimate business interests of the purchaser). They must also prove that the balance of convenience favours the injunction being granted and that they will suffer irreparable injury for which damages are not an adequate remedy, if the injunction is not granted.

When seeking an interlocutory injunction, the purchaser will almost always need to provide an undertaking as to damages. That is, if there is a subsequent trial, and employer is unsuccessful, it agrees, by way of undertaking, to pay all damages which flow from that interlocutory injunction having been granted.

8. RESPONDING TO AN APPLICATION FOR INJUNCTION

The seller will clearly seek to demonstrate that there is no risk that harm will be suffered by the buyer. That is, an injunction is a discretionary remedy, and if there is no need to grant an injunction, then it should not be granted.

9. CONCLUSION

Both enforcing a restraint of trade, and opposing an application seeking one, can be a costly exercise, involving a significant time commitment which tends to distract both parties from their continuing business affairs.

However, from the buyer's perspective, if there is a real risk that its business will be damaged, then circumstances might dictate that for business reasons, the buyer must commit to protecting itself.

From the seller's perspective, if you receive a demand that will prevent you from being able to trade, you might be forced into the position of protecting your livelihood.

The result is that critical analysis should be undertaken at an early stage to understand your rights and duties.

10. HOW WE CAN HELP YOU

Our team can advise throughout the entire purchase or sale transaction, from drafting the contract, through to advice when the transaction ends and, if there is a need, to acting and appearing in litigation to protect your interests and livelihood.