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RESTRICTIVE COVENANTS IN ASSET OR SHARE PURCHASE AGREEMENTS

What are restrictive covenants?

Restrictive covenants are contractual clauses which restrict the way in which a party to a contract can act. There are different types of restrictive covenants in different types of contracts. This guidance note focuses on restrictive covenants in the context of asset or share purchase agreements between the vendor and purchaser of a business.

Where there is a sale of a business and the vendor was also an employee and is to remain an employee, there will often be an overlap between restrictive covenants that might need to be included in the asset or share purchase agreement and any new employment contract. In those circumstances it may also be necessary for you to consider restrictive covenants in an employment context: see further our guidance note **Restrictive Covenants in Employment Contracts**.

This guidance note does not deal with restraints of trade in the context of competition law and specific advice should be sought if that issue is relevant to you or your business.

The object of a restrictive covenant in the context of an asset or share purchase agreement is to restrict the ability of the vendor to sell an existing business and then immediately start a rival concern which would compete with that business and/or poach employees and customers. It is important for the purchaser to protect the business he is buying in this way and it can also be a key consideration for the vendor. If the vendor does not enter into a valid covenant then he could not sell the goodwill of the company as the purchaser would not have the assurance he needs that the vendor will not compete with him in the future.

Types of covenant

In asset or share purchase agreements, restrictive covenants can be categorised as follows:

- non-solicitation of customers
- non-solicitation of employees
- non-compete covenants

The intention of a non-solicitation covenant is to prevent the vendor from approaching customers or employees following the sale of the business in order to poach them for a new business. The restriction will apply for a specified period of time. A non-solicitation clause can be distinguished from a non-dealing clause which would typically attempt to prevent the vendor from general business dealings with former customers or employees. Non-dealing clauses are not commonly used as by definition they could be deemed to be unreasonably wide and therefore unenforceable if challenged in the courts during a dispute: see further **Drafting Restrictive Covenants** overleaf.

If the vendor is to remain as an employee of the company after the sale of the business, he may also be asked to enter into restrictive covenants in his capacity as an employee (ie in his contract of employment or service agreement) as well as in the asset or share purchase agreement.

A non-compete covenant is used as a means of preventing the vendor from competing at all with the existing business. The restriction will apply for a specified period of time and within a specified area.

It is important that any restrictions are drafted carefully; a one size fits all approach to restrictive covenants runs the risk the restriction will be unenforceable.

Drafting restrictive covenants

There is a presumption that all restrictive covenants are void for being in restraint of trade and contrary to public policy. However, a covenant will be upheld and enforced if the party seeking to enforce it can show that:

- it has a legitimate proprietary or business interest that it is appropriate to protect; and
- the protection sought goes no further than is reasonable (having regard to the interests of the parties and the public interest)

Legitimate interest

In broad terms, connections with suppliers or customers, goodwill, trade secrets and other confidential information may be legitimate interests capable of protection. The question is open as to whether business interests or trade secrets or trade connections can be protected and this can be argued before the courts.

Reasonableness

The restriction must be necessary to protect the legitimate interest of the party seeking to enforce it, so must not be too wide. Factors taken into account include the breadth of the geographical area, the length of the restriction and the type of interest being protected. For example, a five year non-compete covenant may well be too long in respect of some businesses but reasonable in relation to others. Typically, non-compete restrictions are three years or less. However, the factors outlined are subject to the overreaching principle of reasonableness. If the test of reasonableness is satisfied the covenant will be enforceable even if it initially appears that the restraint or limit is too wide and requires justification.

For example, a restraint which was unlimited in time has been upheld by the courts as have worldwide restrictions. Both were deemed to be reasonable in the particular circumstances of the disputes concerned.

It is important therefore that any restrictions are drafted carefully; a one size fits all approach to restrictive covenants runs the risk the restriction will be unenforceable. As a general principle, the narrower the restriction, the more likely it is to be enforceable. If a restriction is unreasonable it is possible that the unreasonable part can be severed from the contract by the removal of either part or the whole of the covenant. However, if it cannot be severed, the covenant or possibly the entire contract is rendered unenforceable.

Enforcing restrictive covenants

Where restrictive covenants are breached, action should usually be taken as a matter of urgency. The actions of the vendor may be damaging to the business from day one of the breach and any delay in taking action can make it less likely that an injunction will be granted.

The usual method of enforcement is an application to court for urgent injunctive relief. An injunction in this context will be a court order banning the vendor from undertaking certain activities in order to preserve the position between the parties until their respective rights have been determined at trial. For further information about practice and procedure in this regard and when the court will grant an injunction see our **Injunctions** guidance note.

Alternatively, or if the court refuses to award an injunction, the purchaser can also sue for damages for breach of the restrictive covenants from the vendor. The court will consider the following issues when deciding whether to award damages:

The burden of establishing that a covenant is no more than is reasonable in the interests of the parties is on the person who seeks to rely on it ie the purchaser.

- is the covenant enforceable?
- if yes, has the vendor breached the covenant?
- has the breach caused the purchaser loss?
- if yes, how should that loss be assessed?

The courts will interpret the meaning of the covenant in the same way as it does in relation to any other contractual clause. The courts will endeavour to construe the clause so as to achieve the intention of the parties at the time the agreement was entered into.

The burden of establishing that a covenant is no more than is reasonable in the interests of the parties is on the person who seeks to rely on it ie the purchaser in the context of share and asset purchase agreements. If the purchaser successfully establishes that it is no more than reasonable in the interests of the parties, the burden of proving that it is contrary to public policy would be with the vendor who would be seeking to undo the covenant.

Should you have any questions please contact our Dispute Resolution team on 0161 909 4983

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