

Briefing Note: Imposing Restrictive Covenants in a Business Sale

An Introduction to the Briefing Note

This Briefing Note sets out the different types of restrictive covenants that can be used in a purchase agreement and explains when they are likely to be enforceable. This briefing note should not be relied upon as legal advice and you should contact us for advice on your specific circumstances.

Briefing Note
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What is a restrictive covenant?

If you are buying a business, you will want to prevent the seller from establishing a business that competes with your newly acquired business after the sale. You should provide for suitable restrictive covenants on the seller in the purchase agreement. In some circumstances, you may want to extend the restrictive covenant to the parent company of, or persons connected with the seller. You may also want to prevent the seller from:

- Soliciting existing customers or suppliers of your newly acquired business for a specified period.
- Soliciting and employing existing employees of your newly acquired business for a specified period.
- Competing generally with your newly acquired business within a specified geographical area for a specified period.

Typical restrictive covenants found in a purchase agreement

Non-competition clause

A covenant preventing the seller setting up a new operation in the same line of business may be justifiable for a certain period. It will be more easily justifiable if the trade secrets used in the business you are buying are not protected by, for example, patent or copyright. Secret product formulas are the most obvious example.

Non-solicitation or non-dealing clauses

- The easiest form of restriction to justify is a covenant prohibiting the seller soliciting or canvassing the customers of the business you are buying for a certain period. This should be limited to circumstances where the seller is offering customers goods or services that compete with those of the business you are buying.
- You may have a legitimate concern that customers of the business you are buying may follow the former owner. It is acceptable to require the seller not to deal with former customers, even if the customer makes the approach.
- The acceptable time period should be enough to allow you to obtain the full value of the purchase price paid in the acquisition. Indefinite time periods will be difficult to justify.

Reputation

You can prevent the seller from using a similar name to the business you are buying. You are also entitled to prohibit the seller of an owner-managed business from using a name or description that trades on their association with the business you are buying.

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Stability of the workforce

- Preventing the solicitation of employees may protect a legitimate business interest in the stability of the workforce. Protection is only likely to be enforceable against poaching employees (that is, soliciting them to resign from their employment with the business sold).
- Restrictions prohibiting the offer of employment to employees who have already resigned are unlikely to be enforceable, as they do not protect the stability of the workforce.

Enforceability of restrictive covenants

For a restrictive covenant to be enforceable, it must be reasonable and go no further than is necessary to protect your legitimate business interests. Restrictive covenants must be tailored exactly to the business you are buying. The scope of the business must be defined carefully and you should be aware that the courts may limit the time span for which restraints could be justified.

Time

A two to three year non-compete obligation will generally be acceptable where goodwill and know-how have been acquired. Longer periods may be justified depending on the circumstances.

Scope of activities

The restrictions should be specific to your newly acquired business' products or services.

Geography

- Restrictions should be confined to the territories where your newly acquired business was operating at the time of the transaction (for example, a county or specific urban area).
- You should be careful not to impose restrictions in areas where any of your existing businesses trade, but the recently purchased business does not.

Drafting

Restrictive covenants should be drafted by your lawyer and with caution. They should be drafted to enable a court to strike out only the unreasonable part of the clause, rather than the entire covenant. It is often better to start with a wide covenant and carve out specific exceptions for the seller.

If you have any queries about the content of this Briefing Note or on any aspect of the sale or purchase of a business, please contact Mark Williams on mew@gabyhardwicke.co.uk or on 01323 435900.

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