Restrictive covenants in business sales and purchases

When do you need a restrictive covenant, and what is it?

When a business buyer pays over the purchase price to a seller, they will be conscious that the seller knows the type of business they have just sold. It will be important, therefore, to ensure that the seller does not immediately open a business in competition with the buyer.

This is important as the seller will know the customers, have dealings with them and suppliers, and usually have a more thorough knowledge than the buyer of how to advertise and run the business. Now that they have received the purchase price, it would be unfair for the seller to compete against the buyer. It does happen, however, and this note sets out the type of restrictive covenants that can be used in the business sale agreement and whether they are likely to be enforceable.

This briefing note is not legal advice; if you have any specific issues, you must take specific advice on your circumstances.

What are you trying to prevent the seller from doing?

Ultimately, you want to stop the seller from starting, investing, buying or establishing a business in any way which will compete with your newly purchased business. The purpose of the restrictive covenant is to stop the seller from ruining what you have purchased from them.

The restrictive covenant is a provision in the contract which restricts the seller's activities. You may need to think about the nature of who and what organisation should give the restrictive covenant, but in most cases, when buying from a sole trader, that person will need to enter into those restrictive covenants.

What types of restrictive covenants can you have?

Below are some restrictive covenants you can incorporate into a business sale agreement. This is in no way a complete list, and much will depend on the nature of the business being purchased:

- Non-solicitation of customers, suppliers or staff

  This is the simplest and most common restriction. Upon completion of the business sale agreement, the seller is not permitted to canvass customers, approach staff, and generally (with the knowledge they possess of the business) go after your contacts.

  In many ways, this is the easiest restriction to impose but the most difficult to enforce. You must justify a reasonable time period for the restriction – you cannot say indefinitely.

- Non-solicitation of staff

  You would not want the staff being canvassed and taking their contacts with them. That is a much more difficult position to enforce. The issue will be that while the staff have a right of movement to be employed elsewhere, the business's previous owner will know their value much better than you when you immediately take over the business. If they wish to compete with you, you will want them. This is particularly true of businesses such as hairdressers.

- Geographic restrictions

  Geographic restrictions must also be reasonable, and there is a lot of case law regarding the enforceability of these restrictions. Ultimately, the question will be: Have you suffered any quantifiable loss' because the seller has opened up a shop in competition with you in your area? How far is reasonable? What type of business is it?

- Reputation and goodwill

  A business has a reputation and a customer base. The name, reputation and confidence that customers have in that form the goodwill of a business. To protect this, you would want the goodwill and name transferred to you in a document known as an assignment of goodwill.

  However, you would also want a provision restricting the seller from using a name similar to or the same as the business name. Ultimately, it is always best to register a trademark or patent, but without that, a well-drafted restriction will need to be in the contract.

Enforceability of restrictive covenants

The question with all restrictive covenants is: Is what is being imposed reasonable? It cannot go beyond what would be considered legitimate to protect your business interests. The type, variation and extent of the restrictive covenant will depend solely on the type of business you are purchasing. The courts have the power to remove restrictive covenants from the interpretation of a contract if they believe it is unreasonable. So consider:

- Is a five-year restriction reasonable for a dry cleaning business when two years would perhaps be considered appropriate for that type of business?

- Can you restrict somebody from running 'any retail activity' when they have sold you a clothes store? Probably not. You should be specific about the type of business purchased.

- It would be unreasonable to restrict a geographic area in which you have no business interests. For example, you cannot stop somebody from running a café in Kent when you have purchased one in Sussex.

Conclusion

Restrictive covenants are difficult to draft, and their success is based on the reasonableness of what you are imposing. Ultimately, if a seller wishes to open up in competition with you, you will need to issue proceedings to stop them from damaging your business - which will involve time, cost and effort. To avoid falling at the first hurdle, you should always impose what would be considered fair and have your legal adviser draft the provisions and agree with the other side's legal adviser. You do not wish to allow the court to strike out the entire clause, but only, if applicable, those parts they feel are unreasonable.