

FRANCHISING AND RESTRAINTS OF TRADE – RESTRAINING EX-FRANCHISEES FROM COMPETING WITH THE FRANCHISE NETWORK

TA Woker
BA LLB LLM
Professor, University of KwaZulu-Natal

SUMMARY

Franchising is a method of expanding a business that allows one (the franchisor) who has developed a successful product or service to increase his distribution network through the investment of others (franchisees) who want to own their own businesses. The relationship between the franchisor and his franchisees is extremely complex but at present it is treated as a normal commercial business transaction. Such an approach fails to take into consideration the entire commitment structure that underlies the franchise network. I have examined this in the light of certain cases dealing with restraints of trade and suggest that there is a need to develop a distinct body of law designed specifically to deal with franchising.

1 A BRIEF INTRODUCTION TO FRANCHISING

Franchising is a modern business organisational method that denotes a special kind of relationship between businesses using the same trade symbols and business methods.¹ There has been phenomenal growth in South Africa in this industry over the last 10 years.²

The United States of America is generally regarded as the home of franchising with the Singer Sewing Machine Company's network of sales and service agents being cited as a pioneer in the 1850s.³ The 1960s were

¹ Brown "Franchising – A Fiduciary Relationship" 1971 49 *Texas Law Review* 650. The word is derived from the French word "franchir" meaning "to free". It denotes the fact that franchising affords individuals an opportunity to establish their "own" business and be their own "boss".

² Statistics and information regarding franchising in South Africa can be obtained from the Franchise Association of South Africa (FASA) website www.fasa.co.za

³ Loftstrom "Franchising 101: Registration and Disclosure Issues" paper presented at the 2nd Annual Spring Meeting of the Business Law and the Intellectual Property Section of the State Bar of California April 2001 accessed at <file:///I:/i/Michael&Rob/calbar/buslawnew/spring2001/lofstrom.htm>; Walker and Etzel "The Internationalization of U.S. Franchise Systems: Progress and Procedures" 1973 37 *Journal of Marketing* 38; Rothenberg "A Fresh

regarded as boom years for franchising in America⁴ and although growth slowed in the 1970s⁵ franchising continues to play an important role in its economy.

Franchising began in the 1920s in South Africa with the establishment of the motor manufacturing industry.⁶ The original form was product distribution franchising.⁷ Coca Cola and Pepsi set up subsidiaries in South Africa in 1937 and 1948 respectively and a network of bottlers was established.⁸ Business format franchising⁹ was introduced in the mid-1960s when some leading American franchising companies opened outlets.¹⁰ Amongst the first were Steers, Kentucky Fried Chicken and Wimpy.¹¹

In 1979, the industry had grown sufficiently for the establishment of the Franchise Association of Southern Africa (FASA), originally known as SAFA.¹² This is a non-profit, self-funding organisation with a mission to promote and maintain ethical franchising in South Africa.¹³ The development of the industry was hampered by trade sanctions implemented during the 1980s but there was renewed interest after the first democratic elections in 1994.¹⁴ The recession of that time also contributed to growth because many corporations, parastatals and the government were downsizing. This resulted in a pool of potential franchisees.¹⁵ In the late 1990s the

Look at Franchising" 1967 31 *Journal of Marketing* 52; and Konopa "What is Meant by Franchise Selling" 1963 27 *Journal of Marketing* 35.

⁴ After the Second World War franchising really began to grow in America. The impetus is said to have come from soldiers returning from the war. They had interrupted their studies and many of them felt that they were too old to become college students. The American economy was booming and the Veterans Association guaranteed or insured their business loans. This inspired entrepreneurs with good ideas to become involved in the industry. A number of factors contributed towards growth in the 1950s and 60s. These included rising personal disposable income, increased urbanisation, growing demand for consumer goods and services and rising consumer mobility. See generally Donner "An Overview of Franchising in South Africa" unpublished MBA research paper, Cape Town (1978) 29; Walker and Etzel 1973 37 *Journal of Marketing* 38; and Hunt "The Socioeconomic Consequences of the Franchise System of Distribution" 1972 36 *Journal of Marketing* 33.

⁵ See Hunt 1972 36 *Journal of Marketing* 33 where he explains that this was because many of the advantages and socioeconomic consequences expected of franchising did not materialise. Franchisees found that the extremely attractive profit projections of franchisors were often deceptive; the prices charged by franchisors were exorbitant and franchise agreements were being arbitrarily terminated. Franchisors were affected by increased litigation on the part of franchisees and by the introduction of legislation.

⁶ Charney "Franchising in South Africa – Its Present Position and Potential for Development" unpublished MBL dissertation, University of South Africa (1975) 84 quoted by Donner 30.

⁷ *Ibid.* An explanation of product distribution franchising appears below.

⁸ For a case study regarding the establishment of the Coca Cola Company in South Africa see Seres *Problems in Decision-making: A South African Marketing Approach* (1978) 203-212.

⁹ For an explanation of business format franchising see below.

¹⁰ Charney "Franchising in South Africa – Its Present Position and Potential for Development" (1975) 84 quoted by Donner "An Overview of Franchising in South Africa" (1978) 46.

¹¹ Donner "An Overview of Franchising in South Africa" (1978) 46.

¹² Franchise Steering Committee *National Strategy for the Development and Support of Franchising in South Africa* (2000) 8 available from the Department of Trade and Industry.

¹³ See generally Louw "FASA's Role in the Orderly Development and the Maintenance of Ethical Practices" 2001 *Franchise Book of Southern Africa* 12.

¹⁴ Franchise Steering Committee (2000) 8.

¹⁵ *Ibid.*

government realised that franchising could play a role in wealth and job creation and the empowerment of the previously disadvantaged.¹⁶ The Department of Trade and Industry formed a task team, the Franchise Steering Committee, to investigate how this industry could be regulated.¹⁷ The task team produced a report¹⁸ that recommends the introduction of legislation but nothing has happened to take these proposals further.

South Africa does not have a specific body of law governing franchising. A franchise agreement is therefore treated as a normal commercial contract subject to the same rules and considerations as other commercial matters.¹⁹ When considering legal problems, reference must principally be had to the law of contract as the franchise agreement is the founding document that governs the relationship between franchisor and franchisee. There are also a number of statutes which, although they do not specifically contemplate franchising, are relevant. The most important are the Consumer Affairs Act²⁰ which regulates unfair business practices generally and the Competition Act²¹ which regulates all aspects of business activity in South Africa. Besides the above, franchise industry codes must also be considered as the industry is subject to self-regulation.²²

2 DEFINITION AND NATURE OF FRANCHISING

Franchising has been defined in broad terms as “a business arrangement wherein one party, namely the franchisor, enters into a contractual relationship with another party, namely the franchisee, granting the franchisee rights to use the franchisor’s trade name and trademarks and to conduct a business in accordance with a specified format”. In exchange the franchisee pays the franchisor an initial fee and ongoing management fees or royalties.²³

Normally two kinds of franchises in the business arena can be identified namely:

- product distribution franchising; and
- business format franchising.

¹⁶ Hendricks, Deputy Minister of Trade and Industry 2003 *Franchise Book of Southern Africa* 8.

¹⁷ *Ibid.*

¹⁸ *National Strategy for the Development and Support of Franchising in South Africa* (2000).

¹⁹ See in particular *Juglal NO v Shoprite Checkers (Pty) Ltd t/a OK Franchise Division* 2004 5 SA 248 (SCA); and Potgieter “Franchise Agreements: Some Related Legal Aspects” 2001 *Franchise Book of Southern Africa* 30.

²⁰ Act 71 of 1988.

²¹ Act 89 of 1998.

²² The Franchise Code of Ethics and Business Practices is administered by FASA and the Consumer Affairs Committee also has a Franchising Code. The present state of the law is not satisfactory. I have discussed this in an analysis entitled “Franchising – The Need for Legislation” to be published in the *SA Mercantile Law Journal* (2004).

²³ Business Practices Committee (now known as the Consumer Affairs Committee) *Consumer Code for Franchising* (1995) 1.

2 1 Product distribution franchising

Product distribution franchising is the oldest form of modern day franchising and occurs when the franchisor (manufacturer) allows the franchisee (distributor) to act as a non-exclusive authorised dealer for his products and the franchisee is entitled to use the franchisor's trademark.²⁴ Examples of such franchises are motor vehicle and implement dealers, petrol service stations and soft drink dealers. There is only a limited relationship between the two parties, unlike that found in business format franchising where the franchisor establishes a fully integrated relationship that goes beyond allowing another to use a recognised product and trademark.

2 2 Business format franchising

The idea behind business format franchising is that the franchisor permits franchisees to replicate his successful business formulae. The franchisor provides a full business plan, marketing strategy, operating manuals, ongoing support and training, and he continues to monitor standards and quality throughout the relationship.²⁵ Fast food outlets, hotels and convenience stores are common examples and in recent years most of franchising's growth is attributable to increased business format franchising.²⁶ To be successful a recognised trade name must be combined with a proven methodology of doing business and must be backed up by management controls at the instance of the franchisor.²⁷ The idea behind this control is to detect and prevent problems so that the franchisor's (and the network's) image in the market, which has been built up over time, is maintained.

Although on paper the relationship appears to be relatively unremarkable, it is a highly complex one. It is neither an employment contract, nor is it one in which the franchisee is an independent contractor. A fundamental feature of the relationship is the fact that the franchisee usually makes a large initial financial investment and owns the assets of the (franchisee) business, but the franchisor has the power to determine how those assets are used.²⁸ This distinction between ownership and control has enormous consequences and leads to a relationship that is "highly intimate and interdependent".²⁹ It is not uncommon to describe it in terms of family metaphors.³⁰ Louw, the Executive

²⁴ See generally Beyer "Considerations in the Development of a Franchise System" 1996 *Franchise Law and Practice* § 2; and Byers "Making a Case for Federal Regulation of Franchise Terminations – A Return to Equity Approach" Spring 1994 *Journal of Corporation Law* 613.

²⁵ Beyer 1996 *Franchise Law and Practice* §2.6 and Byers 1994 *Journal of Corporation Law* 614.

²⁶ Byers 1994 *Journal of Corporation Law* 614.

²⁷ It is business format franchising that forms the focus of this article.

²⁸ Hadfield "Problematic Relations: Franchising and the Law of Incomplete Contracts" 1990 *Stanford Law Review* 927 963.

²⁹ *Ibid.*

³⁰ *Ibid.* The author quotes from a number of authors who refer to a franchisor as being a parent or husband.

Director of FASA, describes franchising as a form of business marriage³¹ and a past president of Kentucky Fried Chicken has also used a marriage metaphor to explain the relationship. He describes franchising as:

“[A] wedding. Lots of music, lots of flowers, money exchanging hands and lots of kisses. The couple is from the best of two worlds; one of the partners is experienced, with plenty of good know-how, with a proven system; and the other partner is a virgin, who hopefully has never been in business before. The vows they exchange are almost the same as you exchanged when you married your wife. The virgin bride must have a burning desire to be ‘his’ own boss and to run ‘his’ own business.”³²

This very unique business relationship involves many areas of law such as competition, product liability, intellectual property and, most importantly, contract. Unfortunately the uniqueness of this relationship is not always adequately understood, not only by the parties but also by the courts, and this causes difficulties when disputes arise.³³ Byers explains that conflicts are inherent in the very structure of franchising.³⁴ The cornerstone of the relationship is the franchise trademark because this symbolises uniformity of quality of the franchisor’s goods and services.³⁵ Franchisors have a strong need to ensure that their trademarks are protected. They demand that franchisees maintain their ethos so that national goodwill is developed that will enhance the investment made by franchisors as well as by all complying franchisees. Franchisees that depart from their franchisor’s methodology potentially expose the trademark to harm.

But the system does lend itself to franchisor opportunism.³⁶ This is where the franchisor will exercise its power to terminate franchise relationships in order to unfairly capitalise on the goodwill built up by franchisees through the latter’s investment of capital and labour. On the other hand, rogue franchisees can engage in “free riding”.³⁷ This occurs when franchisees or ex-franchisees benefit from the national goodwill created by the franchise structure without conforming to stipulated standards and requirements. Such conduct is detrimental to the whole network. One way in which franchisors protect their proprietary interests and the interests of their whole franchise structure is through restraints of trade.³⁸ These are regarded as an essential component of franchise agreements but enforcing these restraints has been

³¹ Low 2001 *Franchise Book of Southern Africa* 14.

³² See Hadfield 1990 *Stanford Law Review* 964.

³³ Byers 1994 *Journal of Corporation Law* 620.

³⁴ *Ibid.*

³⁵ *Ibid.*

³⁶ Byers 1994 *Journal of Corporation Law* 620; and Hadfield 1990 *Stanford Law Review* 951-953. Franchisor opportunism is a recognised form of franchisor abuse and has been dealt with in other jurisdictions through legislation. *Eg*, in many states in America, franchisors may not refuse to renew agreements without good cause. See, *eg*, the California Franchise Relations Act enacted in 1980. These laws provide franchisees with a remedy if franchisors act capriciously or vindictively. The courts will scrutinise reasons for refusal to renew (Baer, Carter and Miller “Lessons Learned from Three Decades of Franchise Regulation and Litigation in the United States” unpublished paper presented at the International Bar Association Conference, San Francisco (2003) 39).

³⁷ Byers 1994 *Journal of Corporation Law* 620.

³⁸ Also referred to as non-competition clauses.

particularly difficult in South Africa.³⁹ It is suggested that this difficulty is the result of the courts not really understanding the nature of the relationship between the parties.

3 RESTRAINTS OF TRADE

In a classical business format franchise relationship, the franchisor will transfer to franchisees all his business knowledge including successes, image, and manufacturing and marketing techniques. The franchisor will also seek to restrict franchisees from engaging in a similar trade, business or occupation during the relationship and for a reasonable period after its termination.⁴⁰ Generally speaking, a restraint of trade is acceptable if it is intended to protect a legitimate interest.⁴¹ It is this concept of a legitimate interest that has caused difficulty for the South African courts.

In *Magna Alloys v Ellis*⁴² the Appellate Division (now the Supreme Court of Appeal) held that a restraint of trade is *prima facie* valid, but the court will not enforce it to the extent that enforcement would be contrary to public policy. The rules laid down in *Magna Alloys v Ellis* were refined in *Basson v Chilwan*⁴³ where the court in the majority judgment suggested that four questions should be asked:

- Does the claiming party have a protectable interest?
- Is this interest being prejudiced by the other party?
- If so, is this interest such that, when weighed qualitatively and quantitatively against the interests of the other party, the latter should be rendered economically inactive and unproductive? And finally, quite apart from the interests of the two parties,
- Whether the interests of public policy are such that the restraint should either be enforced or voided?⁴⁴

³⁹ See, eg, *U-Drive Franchise Systems Ltd v Drive Yourself Ltd* 1976 1 SA 137 (D&CLD); *Amalgamated Retail Ltd v Spark* 1991 2 SA 143 (SECLD); *Pam Golding Franchise Services (Pty) Ltd v Douglas* 1996 4 SA 1217 (D&CLD); and *Kwik Kopy (SA) (Pty) Ltd v Van Haarlem* 1999 1 SA 472 (WLD). I have specifically refrained from dealing with the situation where a franchisee is the victim of franchisor opportunism or there is deliberate free riding on the part of a franchisee. My focus is to place restraints of trade within the context of the structure of franchising as a whole. I make no judgement regarding the correctness or otherwise of the various decisions discussed because, it is my submission, the focus of the debate has been too narrow.

⁴⁰ Manufacturers and producers that have used franchising to preserve and enlarge their market share may bind a franchisee to deal exclusively with that manufacturer or producer. This form of restraint is known as a tying arrangement and raises important issues relating to competition. A discussion of such restraints is beyond the scope of this article and I will focus on restraints of trade that seek to prevent franchisees from competing with the franchisor after the relationship has terminated.

⁴¹ A full discussion of the principles relating to restraints of trade is beyond the scope of this article but see Kerr *The Principles of the Law of Contract* 6ed (2002) 181-235; Sharrock *Business Transactions Law* 6ed (2002) 106-113; and Christie *The Law of Contract in South Africa* (2001) 417-435.

⁴² 1984 4 SA 874 (A).

⁴³ 1993 3 SA 742 (A).

⁴⁴ *Basson v Chilwan supra* 767G-H.

These questions raise at least two issues as far as franchising is concerned, namely: who is the claiming party and what interest is the restraint seeking to protect?

3 1 The claiming party

The franchisor seeking to ensure that a restraint is upheld is not acting merely to protect his own interests but also the interests of the entire franchise operation. Non-rogue franchisees have a considerable interest in ensuring that the franchise system is protected.⁴⁵ In Germany for example, non-competition clauses are, as a rule, not considered unfair provided they *inter alia* serve to protect the legitimate interests of the franchise system.⁴⁶ Similarly in France, the courts have said that non-competition clauses are justifiable provided they provide the franchise network with necessary protection without imposing undue restraints.⁴⁷ A report regarding an American dispute involving Dunkin' Donuts indicates that the thrust of the franchisor's argument is that a reasonable restraint is necessary in order to preserve the franchising system and to protect the interests of Dunkin Donut's other franchisees.⁴⁸ In the same matter the International Franchise Association (IFA)⁴⁹ has submitted a "friend of the court" brief. It refers to the rights of both franchisors and franchisees, and suggests that other franchisees, being non-litigants, are also entitled to protection because they have invested substantial amounts in the franchisor's trademark through their businesses.⁵⁰

An examination of South African decisions suggests that the courts tend to approach disputes by considering only the interests of the franchisor. This is problematic because, as is pointed out in a number of decisions,⁵¹ franchisors and franchisees are not in the same business. The franchisee is in the business of providing products or services whilst the franchisor is usually in the business of selling franchises. This was central to the decision in *Pam Golding Franchise Services (Pty) Ltd v Douglas*⁵² involving an estate agency franchise. The contract contained a restraint clause which provided

⁴⁵ Rogers and Wasyliv "Restrictive Covenants in Franchising – Drafting and Enforcement" 2001 available at www.davis.ca.

⁴⁶ Organisation for Economic Co-operation and Development (OECD) *Competition Policy and Vertical Restraints: Franchising Agreements* (1993) at www.oecd.org/dataoecd/34/53/1920362.pdf. The OECD, with 30 member countries and an active relationship with 70 others, produces internationally agreed instruments, decisions and recommendations to promote rules for a globalised economy. In June 2004 it was reported that South Africa was to intensify its co-operation with the OECD by becoming observers in its Committee on Fiscal Affairs (CFA). See www.oecd.org.

⁴⁷ *Mourat-Natalys* Paris Court of Appeal (1989) quoted by OECD 148.

⁴⁸ *Dunkin Donuts v Boulanger* Massachusetts June 2003 reported by Sparks *IndusBusiness Journal on line* at www.indusbusinessjournal.com/news/2004/05/15/FranchiseHospitality. The trial court held in favour of the franchisor and the matter is now on appeal to the Massachusetts Supreme Judicial Court.

⁴⁹ This is a trade association of franchisors in the United States of America formed in 1960.

⁵⁰ *Dunkin Donuts v Boulanger* Massachusetts June 2003 reported by Sparks *IndusBusiness Journal on line* at www.indusbusinessjournal.com/news/2004/05/15/FranchiseHospitality 3.

⁵¹ See, eg, *Pam Golding Franchise Services (Pty) Ltd v Douglas supra*; and *Kwik Kopy (SA) (Pty) Ltd v Van Haarlem supra*.

⁵² *Supra*.

that the franchisee would not during the existence of the contract and for a period of two years after the termination thereof, be concerned in any business similar to or competitive with that carried on by the franchisee in the area. A dispute arose between the parties and so the franchisee closed the premises where she had been trading and moved to another office where she managed another franchise under the name of a different estate agent. When the franchisor attempted to interdict her from acting in contravention of the restraint, the franchisee argued that the restraint was contrary to public policy because it was an unreasonable restriction on her freedom to trade. The court focussed on the fact that the franchisor was not operating as an estate agent. The franchisor's trade was that of franchising the use by others of the name and other indicia of the specific operation to which the goodwill of that operation adhered. It further made available to franchisees its expertise and information which would facilitate their trading under the name Pam Golding. The court found that the interest which could be protected was the franchisor's interest in protecting and enhancing the Pam Golding name. Therefore, as long as the franchisee was operating under a new name, she could not be prevented from doing so.⁵³ The court maintained that whilst the franchisor had the right and obligation to ensure that the goodwill of the business was not in any way diminished by competition *under the same name*, it was not entitled to protect the business of a subsequent franchisee against competition in general.⁵⁴

It is not possible to speculate whether the ultimate decision of the court is correct because the focus of the enquiry was too limited. The franchisor has an interest to protect the whole network and therefore the interest of the network as well must be considered and not only the interest of the franchisor. If the franchisor could have shown that the financial stability of the entire network is prejudiced when franchisees disregard their restraints, the matter might have been decided differently. There is nothing in the judgment to suggest that the interests of the other franchisees were considered.

A similarly narrow approach can be found in *U-Drive Franchise Systems Ltd v Drive Yourself Ltd*⁵⁵ where the franchisor contended that the parties had contemplated that the franchisee would build up a business using the franchisor's name, and that on termination of the franchise agreement the business so built up would belong to the franchisor who was accordingly entitled to be protected against competition from the franchisee for a reasonable period. The court did not accept this and held that whilst the franchisor was entitled to protection of trade connections built up by itself, the customer connections built up by the franchisee even whilst using the franchisor's name remained the property of the franchisee.⁵⁶ This approach, it is submitted, is too narrow because it ignores or makes no allowance for the goodwill that attaches to the franchisor's trademarks and name. In a successful franchise operation, goodwill is contributed to by all franchisees. A person living in Pretoria for example, may patronise a particular restaurant

⁵³ *Pam Golding Franchise Services (Pty) Ltd v Douglas supra* 1224G-H.

⁵⁴ *Pam Golding Franchise Services (Pty) Ltd v Douglas supra* 1225D-E.

⁵⁵ *Supra*.

⁵⁶ *U-Drive Franchise Systems Ltd v Drive Yourself Ltd supra* 142E-F.

when on holiday in Kwazulu-Natal because she recognises the trade name, is aware of its reputation and because she frequents the restaurant in Pretoria. All successful franchisees contribute to the development of goodwill. Therefore, it is the interests of the network as well that must be considered when deciding whether or not to enforce a restraint.

3 2 The protectable interest

The problem with franchising is that it does not fit neatly into one of the more commonly recognised categories of restraint, namely those found in sales of goodwill and those in employment contracts. The franchisee does not sell a business with its goodwill to the franchisor and neither does he work for the franchisor. A study of the few South African cases that deal with this difficult issue indicate that the parties and the courts have struggled to identify exactly what interest the restraint is seeking to protect. In fact, in all the reported decisions involving franchising, the South African courts have found the restraints to be unenforceable because of an inability to identify a protectable interest. The problem is that the arguments have centred on the principles relevant to the sale of goodwill and employment contracts, none of which have proved satisfactory.

Where the sale of a business or professional practice is involved, the purchaser wishes to protect himself from future competition by the seller in the same geographical area for a certain period of time and by including a restraint clause in the sale agreement, the seller creates a saleable asset, namely the goodwill of the business.⁵⁷ Usually the parties are contracting as equals and because the restraint is for the benefit of both parties the courts tend to view such restraints more favourably than when dealing with those found in employment contracts. As far as a franchise is concerned, the franchisor sells its business model to a franchisee. The franchisee then exploits and enhances the goodwill attached to the trademark. When the franchisee leaves the network the franchisor seeks to prevent the ex-franchisee from capitalising on that goodwill any further, despite the fact that the franchisee has not been remunerated therefor. The difficulty for the franchisee is that the contract may terminate without the franchisee selling the business to a new franchisee and the franchisor does not compensate those that leave the network.⁵⁸ It is therefore difficult to apply the principles

⁵⁷ The goodwill of a business is a combination of all the factors which help to attract customers or clients to that business. Often the main elements of goodwill will be the name and location of the business. Especially where the personality of the previous proprietor of the business plays a part, the purchaser of the goodwill has an interest in excluding the seller from opening or taking over or conducting a competing business where his personality will play a part, until after a lapse of that reasonable period which is necessary for the purchaser to establish his own relationship with the customers of the business. The goodwill of a business has a separate identity and can be valued apart from the material assets of the firm. See, eg, *Diner v Carpet Manufacturing Co of SA* 1969 2 SA 101 (D&CLD); and *Cowan v Pomeroy* 1952 3 SA 646 (C).

⁵⁸ Franchises are granted for a limited period of time such as 10 or 20 years and there is no obligation on a franchisor to renew the franchise. This is where franchisor opportunism can arise because a franchisor may choose to capitalise on a successful business by refusing to renew a contract, instead choosing to sell it to a new franchisee for a significant franchise

found in cases dealing with goodwill restraints to franchise matters mainly because the ex-franchisee is restrained from competing but is not compensated for this.⁵⁹

Dealing with employment contracts, employers may use restraints to prevent their employees from competing with them once the employment relationship is terminated. The courts view these restraints far more strictly because it is usually assumed that the parties are not in an equal bargaining position. Unlike in the case of goodwill restraints, mere competition as such cannot be restrained as it is clearly against public policy to prevent a person from earning a living.⁶⁰ However, an employer can validly restrain employees from using confidential knowledge such as trade secrets or special processes or confidential knowledge about clients or customers acquired during employment.⁶¹

Where a franchisee by virtue of the franchise has had access to protectable information confidential to the franchisor and the franchise network and, objectively speaking, there is a reasonable possibility that the franchisee may use these trade secrets in a new business, the court will, in all probability, uphold an appropriate restraint. In this respect using employment restraint principles as a guide is useful but it is still problematic because franchise agreements often involve business people contracting as equals who should be bound by the agreements they sign.⁶² In a recent Canadian decision, for example, the court explained that a franchise agreement is "mutual rather than unilateral, unequal or undue".⁶³ The problem is also compounded by the fact that an employer cannot restrain an employee simply because he learned his trade and acquired certain skills whilst working for the employer.⁶⁴ Neither can the employer argue that he spent time and resources training the employee.⁶⁵ When it comes to franchising, the core of the franchisor's business is its method of doing

fee. See generally Byers 1994 *Journal of Corporation Law* 620; and Hadfield 1990 *Stanford Law Review* 951-953.

⁵⁹ From the franchisor's point of view the ex-franchisee has had the benefit of gaining experience and developing that goodwill whilst using the name, symbols and know-how of the franchise system. The "break-away franchisee" syndrome can be a problem for the entire network as the franchisor will lose revenue and it may be difficult to sell to new franchisees when "old" ones continue to operate a similar business in the same area. The financial stability of the franchise could be threatened. The breakaway franchisee syndrome refers to the unilateral termination of the franchise agreement by franchisees. See generally Beyer 1996 *Franchise Law and Practice* § 2.47.

⁶⁰ *Highlands Park Football Club v Viljoen* 1978 3 SA 191 (W).

⁶¹ *Thompson v Nortier* 1931 OPD 147 (T).

⁶² See generally Knack and Mooty "Recent Developments Affecting Franchising in the United States" unpublished paper presented at International Bar Association Conference, San Francisco (2003) where they reported that the Federal Trade Commission (FTC) believes that franchises are sold internationally "to sophisticated investors who are generally represented by counsel or who can otherwise protect their own interests". There is a dispute about how franchisees should be treated, as consumers or as sophisticated business people, but such a discussion is beyond the scope of this article.

⁶³ *Ellis v Subway Franchise Systems of Canada Ltd* (2000) 8 BLR (3d) 55 (Ont SCJ) quoted by Adler and Zaid "Franchising in a New World of Disclosure" unpublished paper presented at the Ontario Bar Association Conference (2003) 16.

⁶⁴ See in particular *Highlands Park Football Club v Viljoen supra*.

⁶⁵ *Highlands Park Football Club v Viljoen supra*; and *Basson v Chilwan supra*.

business. One of the advantages of franchising is that inexperienced business people are “mentored” by someone who has developed a successful business model.⁶⁶ The franchisor in *Kwik Kopy (SA) (Pty) Ltd v Van Haarlem*⁶⁷ failed to persuade the court to recognise that this know-how was a protectable interest.⁶⁸ The court accepted that trade secrets and confidential information such as secret processes, special recipes and methods of preparation in the food industry may be protected but not training a franchisee to become successful in business. The court found that the franchisor did not have a protectable interest despite the fact that the franchisee had reaped the benefit of being a franchisee with Kwik Kopy and could now continue trading in a similar business without having the obligations of a franchisee.

The *Kwik Kopy* approach is to be compared to the approach adopted by the European Commission Court of Justice which has recognised this concept of know-how.⁶⁹ The first case to come before the court was *Pronuptia v Schillgallis*⁷⁰ where it held that certain restrictive covenants were not anti-competitive because:

“(Franchising) is a way for an undertaking to derive financial benefit from its expertise, without investing its own capital (and) gives traders who do not have the necessary experience access to methods which they could not have learned without considerable effort and allows them to benefit from the reputation of the franchisor’s name ... Such a system, which allows the franchisor to profit from his success, does not in itself restrict competition.”⁷¹

The court pointed out that for a franchise system to work “the franchisor must be able to communicate his know-how to the franchisees and provide them with the necessary assistance in order to enable them to apply his methods without running the risk that the know-how and assistance might benefit competitors, even indirectly”.⁷² As a consequence, the court held that provisions that are necessary to ensure that the know-how and assistance provided by franchisors does not benefit competitors and provisions which establish the control necessary for maintaining the identity and reputation of the network do not constitute restrictions on competition.⁷³

The OECD explains that the transfer of know-how and the supply of technical skills is a defining characteristic of business format franchising.⁷⁴ It then elaborates as follows:

“Know-how and technical skills may result from a firm’s accumulated experience, from some forms of research and development, from testing different ways of doing business, or from a particular innovation. In any event,

⁶⁶ See arguments of the IFA in *Dunkin Donuts v Boulanger supra*.

⁶⁷ *Supra*.

⁶⁸ *Kwik Kopy (SA) (Pty) Ltd v Van Haarlem supra* 486E.

⁶⁹ OECD 83.

⁷⁰ (1986) ECR 353. The case involved a franchise operation that supplied bridal wear and accessories in France and other European countries.

⁷¹ Par 15.

⁷² Par 16.

⁷³ *Ibid*.

⁷⁴ OECD 53.

the value of the know-how is created by some sort of investment (and) (f)irms need to be rewarded by earning returns of investments in know-how.”⁷⁵

The OECD maintains that competition policy must provide an incentive for those with accumulated know-how and skill to transfer this to others and firms must be rewarded by earning returns on investments in know-how.⁷⁶ Therefore, franchise agreement provisions must increase incentives to invest in know-how by limiting unauthorised use of this know-how.⁷⁷ The OECD states that this is particularly important when the franchisor’s know-how concerns “experiences in conducting business something especially difficult to protect in more standard ways, for example, by the use of patents or licensing agreements.”⁷⁸ It concludes that limits on the franchisee’s rights to compete after the franchise agreement is terminated can be justified and points out that many countries have decided to allow such post-termination restrictions.⁷⁹

The concept of know-how may be difficult to define but it is fundamental to understanding the whole concept of franchising. The idea behind franchising is that a successful entrepreneur, who through trial and error has established a successful business model, then uses the knowledge that has been gained to train other, less experienced business people to establish their own successful businesses. It is this know-how that is communicated to others and it is this know-how that is of commercial value. It is this know-how that the franchisor trades in and it is therefore suggested that it is time that it be recognised, in a proper case, as a protectable interest.

4 CONCLUSION

Franchising is a relatively new form of doing business which has developed quite significantly recently. If it is to fulfil expectations of providing a gateway for entrepreneurs to contribute successfully to the economy, proper attention must be paid to understanding its nature and to developing new rules which will facilitate growth and development. The South African cases dealing with restraints of trade in franchising agreements suggest that the nature of the franchise relationship has been misunderstood. Furthermore the application of the legal principles applicable to goodwill and restraint clauses in employment contracts has not really proved to be convincing. At very least these principles need some serious refining so that they are franchise relationship specific. Franchising should not be regarded purely as a normal commercial contract. Rather, it should be recognised as a particular way of doing business, just as, for example, a partnership is so recognised. Hadfield refers to it as an incomplete contract because it involves an ongoing relationship that requires flexible responses to uncertain future

⁷⁵ *Ibid.*

⁷⁶ *Ibid.*

⁷⁷ *Ibid.*

⁷⁸ *Ibid.*

⁷⁹ OECD 176. The report examines the law in Australia, Belguim, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Japan, New Zealand, Norway, Portugal, Spain, Sweden, United Kingdom, United States and European Community. In most instances the period is limited to one year.

conditions.⁸⁰ She further explains that “in franchising’s world of incomplete contracting the courts must strive to identify the entirety of the commitment structure that underlies the franchising arrangement” in order to satisfactorily enforce franchising commitments.⁸¹ A franchise agreement is not simply an agreement between franchisee and franchisor. The commitment structure involves the whole network and so the interests of other franchisees must be considered when evaluating a restraint of trade. There is a need to develop a distinct body of law designed specifically to deal with franchising. This body of law must recognise the particular problems which arise from the conflicts inherent in the franchise relationship and must give expression to the legitimate expectations of all parties that have committed substantial time, effort and resources to the development of a successful franchise network.

⁸⁰ Hadfield 1990 *Stanford Law Review* 927-928. *Cf De Beer v Keyser* 2002 1 SA 827 (SCA) where the Supreme Court of Appeal held that where the subject of a franchise agreement which is to endure for many years is a method of doing business the parties will often intend that its content might vary from time to time to account for changed circumstances, for business methods must necessarily be adapted and altered if the business is to remain competitive. The court also held that in the circumstances it cannot be expected that the specific content of all obligations will be spelt out in detail and that it is sufficient if their content can be ascertained by reference to surrounding circumstances. So the words used in the contract had to be assessed in their context and “measured against what is required for the conduct of a business of the kind to which they relate” (835F-J).

⁸¹ Hadfield 1990 *Stanford Law Review* 983.