

## Franchising - Japan

### Non-compete clauses and liquidated damages in franchise agreements

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### Introduction

Franchisors, as brand owners, often seek to protect their brands and the recognition thereof by including in franchise agreements certain non-compete obligations that must be met by the franchisees during or after the term of the agreement. Such non-compete clauses often have corresponding liquidated damages clauses. Such a non-compete clause is indispensable to protect a brand, but if the clause is excessively restrictive, a court may find it to be partly or entirely invalid under Article 90 of the Civil Code (ie, it may be deemed invalid from a public policy standpoint) or it may be subject to administrative scrutiny and penalties under the Anti-monopoly Act. This update considers various factors under Japanese law that should be considered when drafting or reviewing such non-compete clauses and liquidated damages clauses in franchise agreements.

### Judicial precedent on validity of non-compete clauses

According to published judicial precedents, Japanese courts have tended to regard non-compete clauses in franchise agreements as valid. They have also tended to order franchisees in breach of such clauses to (i) compensate the franchisor (usually on the basis of the corresponding liquidated damages clause), and (ii) cease carrying on a competing business in violation of a non-compete clause. However, in some cases the court has rejected the non-compete clauses or restricted the liquidated damages clauses.

In most instances, the court will decide whether a non-compete clause is valid by balancing: (i) the need to protect the franchisor's established relationships with customers in the relevant geographical trading area - termed the 'commercial right' - and the franchisor's know-how by prohibiting certain competing businesses; and (ii) the extent of the restrictions of the non-competition obligations.<sup>(1)</sup> The reasonableness of the restrictions will be judged on the basis of:

- whether the geographical area of restriction is limited to the place where the franchisee operates (or previously operated) under the franchise agreement;
- whether the scope of business thus restricted is limited to the type of business that the franchisee operates (or previously operated) under the franchise agreement; and
- how long the non-compete period is.

Balancing the commercial factor and the extent of the restrictions is critical in determining the validity of a non-compete clause. All or part of a non-compete clause will be deemed an unreasonable restriction on the franchisee's freedom to operate its business, and will therefore be declared void on public policy grounds, if: (i) there is little or no commercial right or know-how provided by the franchisor that must be protected by the non-compete clause; or (ii) restrictions in the disputed non-compete clause go beyond what is necessary to protect the commercial rights or the know-how in the specified geographical area.

A Tokyo District Court judgment of March 9 2009 is one of the few court decisions to have declared a non-compete clause to be void. In this case, the court rejected the existence of the franchisor's commercial right and the secrecy and value (ie, the need for protection) of the know-how that the franchisor had provided. The court concluded that the extent of the restriction under the non-compete clause was too stringent to endorse, judging that the need to protect the franchisee from the excessive restrictions under the clause outweighed the need to protect the franchisor's possible economic rights under the agreement. Therefore, the court determined that the non-compete clause was void because it was against public policy.

The evaluation of the need to protect commercial rights and know-how may vary, depending on whether the franchise agreement has expired or was terminated before its expiry date. In most cases in which the validity of a non-compete clause has been challenged, the franchise agreement had been terminated before the expiry date, usually due to the franchisee's breach. In such cases a court would be likely to identify a need to prohibit competing business. By contrast, where the franchise agreement has expired, the rationale of prohibiting competing business is less persuasive, as a franchisor might reasonably expect the expiry of the agreement and is able to make appropriate

preparations (eg, seeking a new franchisee in the relevant area). However, in a few instances involving an expired franchise agreement, the court has affirmed the validity of the non-compete clause. As such, it is difficult to determine, solely on the basis of the reason for termination, whether a court will find a non-compete clause invalid.

## Franchise guidelines

Following a number of judgments regarding the validity of non-compete clauses in franchise agreements, on April 24 2002 the Japan Fair Trade Commission revised its Guidelines Concerning the Franchise System, which provide guidance regarding the restrictions on franchise businesses as set out under the Anti-monopoly Act. The guidelines basically follow the method used by the courts to balance the need to protect commercial rights against the extent of the restrictions.

Section 3(1) of the guidelines states that when the restrictions in a non-compete clause exceed the term, stringency or geographical scope necessary to preserve the franchisor's commercial rights in the specified geographical area, or to protect the know-how that the franchisor has provided to the franchisee, the non-compete clause may be deemed an abuse of dominant bargaining position, which is prohibited as an unfair trade practice under Article 19 of the act.

Therefore, when considering whether a non-compete clause will violate the act, it is advisable to carry out such an analysis as generally undertaken by the courts.

## Importance of liquidated damages clause

The liquidated damages clause is one of most important protections available to a franchisor. In Japan, a franchisee can operate its business in violation of a non-compete clause, even if a franchisor is successful in litigation against the franchisee and the latter is ordered to pay compensation and cease its competing practices.

This scenario is possible because although Japanese courts will usually render a provisional execution order for a payment to be made, they are reluctant to render provisional execution orders to prohibit an activity (ie, to provide injunctive relief). As the average duration of court deliberations at trial-court level is approximately 12 to 18 months, potentially followed by between six and 12 months at the appellate level, a franchisee may be in competition with the franchisor for between one and three years.

Moreover, despite the fact that a court may have rendered a provisional execution order to make a payment, it is difficult to prove the actual damages that a franchisor suffered due to a franchisee's violation of a non-compete clause. Therefore, the liquidated damages clause is a vital tool in protecting a franchisor's interests.

However, if a liquidated damages clause stipulates an excessive amount of liquidated damages, it may be declared partially or wholly invalid or may be deemed a breach of the act. The courts generally restrict the amount of damages to be compensated to a reasonable level. This is typically an amount equivalent to the royalties to be paid to the franchisor for (i) the allowable term of the non-compete obligation (ie, no more than approximately two or three years), or (ii) the period of the franchisee's violation of the non-compete obligation. If the liquidated damages clause is declared entirely invalid, the franchisor must prove the actual damages arising from the franchisee's violation of the non-compete clause.

## Comment

It is evident from court precedents and the guidelines that a franchisor, when preparing a franchise agreement, must carefully consider whether the extent of restrictions in the relevant non-compete clause is reasonable in proportion to the need to protect the franchisor's commercial rights or know-how.

Moreover, it is advisable for a franchisor to include a liquidated damages clause in such franchise agreement as an added layer of protection in the event of a violation of the non-compete clause by the franchisee. However, the amount stipulated in such clause should be set at a reasonable level in order to avoid being deemed by the court to be a violation of the Anti-monopoly Act.

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## Endnotes

(1) The Kobe District Court judgment dated July 20 1992 is regarded as the leading case with respect to this factor.

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