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**Don't Stop Me Now: Updating the Current Legal Status  
of Contractual Provisions Restricting Competition**

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## I. INTRODUCTION

### A. Franchisor Interests in Having and Enforcing In-Term and Post-Term Covenants Against Competition

Most franchise agreements contain a covenant not to compete, which includes an agreement not to operate or have an interest in another business that directly or indirectly competes with the franchised business. The covenant not to compete usually covers the term of the franchise agreement (in-term covenant not to compete) and a certain specified period thereafter (post-term covenant not to compete). It generally prevents the franchisee from competing within a certain area of the franchised business and within a certain area of other franchise locations and company-owned locations.

Franchisors have a number of interests in having and enforcing covenants not to compete. Those interests include protection of the franchisor's goodwill, protection of the franchisor's confidential business information and trade secrets, protection of the franchisor's specialized operating methods and training, and protection of the system by ensuring franchisee loyalty to the system and by safeguarding the interests of current franchisees. Franchisors require covenants not to compete, because they are sharing valuable and confidential information with the franchisee and without the covenant not to compete franchisors risk that franchisees will walk away with the information and unfairly compete either in-term or post-termination.

### B. Competing Interests of Franchisees in Limiting the Scope of Covenants Against Competition in Their Franchise Agreements

Franchisees' main interest in avoiding enforcement of covenants not to compete is the ability to continue working in the same trade or profession around which they have built their careers. The geographic and temporal restrictions that are generally deemed 'reasonable' post-termination restrictions, including broad prohibitions against competition within a certain radius of "any franchisee" of the system, make it impractical for a franchisee to work in the same field without making major life changes. While franchisees are generally willing to accept restrictions on the use of a franchisor's confidential information, they are troubled by what amounts to a sweeping prohibition on their continuation in the marketplace as a small competitor. Franchisees who have become dissatisfied with their franchisor or franchise system chafe at the notion of restrictions that will benefit an underperforming franchisor. Many franchisees feel victimized by a legal landscape that favors large corporate franchisees, who have the bargaining power to negotiate out of non-compete clauses, over the 'little guy' franchisee who is expected to toe the line to his or her economic detriment.

## II. JUDICIAL LANDSCAPE

### A. Are Courts Construing Covenants Against Competition More Strictly or More Leniently?

While it is difficult to make a general pronouncement about how "courts" are construing covenants, it is clear that courts in California and the legislature in Georgia present a microcosm of the changing landscape.

## 1. California

California continues to be known as a state that condemns covenants against competition. Over the years, some federal court decisions had complicated the California legal landscape by carving out exceptions to California's statutory prohibition against covenants not to compete, upholding and enforcing the clauses in cases "where one is barred from pursuing only a small or limited part of the business, trade or profession."<sup>1</sup> This "narrow restraint" exception was premised on the notion that a restriction against competition was enforceable under California law so long as it did not completely prohibit a former employee from engaging in his or her trade or profession. The California Supreme Court put a definitive end to this so-called "narrow restraint" exception in a 2008 case, *Edwards v. Arthur Anderson*.<sup>2</sup> The *Edwards* court refused to enforce a covenant against Edwards, which sought to prohibit the former employee from performing any of the same professional services he had performed while at Arthur Anderson for 18 months, and refused to enforce a non-solicitation clause, which sought to preclude Edwards from soliciting clients of the firm for one year. The court found both clauses restricted Edwards' ability to practice his accounting profession and explicitly rejected the notion that California law recognizes a "narrow restraint" exception to the prohibition on covenants against competition.

In addition to rejecting non-competition clauses, California courts also limit the enforceability of non-solicitation clauses unless they are narrowly drafted to protect trade secrets. A broad clause prohibiting solicitation of customers or clients is not sufficiently targeted to withstand scrutiny, as illustrated by the holding in *Dowell v. Biosense Webster, Inc.*<sup>3</sup> In *Dowell*, the non-solicitation clause sought to prohibit a former employee from soliciting any business from, selling to, or rendering any service to any of the accounts or customers he had serviced during the last 12 months on the job. The court found the clause facially void as a broad restraint on the former employee's ability to compete. As another California court put it, "in the absence of a protectable trade secret, the right to compete fairly outweighs the employer's right to protect clients against competition from former employees."<sup>4</sup>

## 2. Georgia

Georgia, on the other hand, as a result of statutory changes regarding covenants not to compete, appears as though it will now construe covenants not to compete more liberally. In a recent case decided pursuant to the law prior to the new statute, *Fantastic Sams Salons Corp. v. Maxie Enterprises, Inc.*,<sup>5</sup> Georgia's historically strict construction of covenants not to compete was exemplified. In that case, the Middle District of Georgia held that the post-term non-compete covenant contained in Fantastic Sams' franchise agreement was unenforceable under Georgia law in effect prior to November 2, 2010, citing *Atlanta Bread Co. Int'l v. Lupton-Smith*.<sup>6</sup> In its holding, the court in *Fantastic Sams* noted that, under Georgia law, restrictive covenants in

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<sup>1</sup> *Campbell v. Trustees of Leland Stanford Jr. Univ.*, 817 F.2d 499, 502 (9th Cir. 1987).

<sup>2</sup> 189 P.3d 285 (Cal. 2008).

<sup>3</sup> 179 Cal. App. 4th 564 (2009).

<sup>4</sup> *American Credit Indemnity Co. v. Sacks*, 213 Cal App. 3d 622, 634 (1989).

<sup>5</sup> 2012 WL 210889, (M.D. Ga. Jan. 24, 2012).

<sup>6</sup> 679 S.E.2d 722, 723 (Ga. 2009).

franchise agreements are subject to strict scrutiny and “must be reasonable as to time, territory and scope.”<sup>7</sup> The court held that the time (2 years) and territory (5 miles) restrictions were reasonable, but the scope restriction was not. Specifically, the court held that the restrictive covenant’s prohibition against employment “in any other capacity” with a competing business was overbroad and unenforceable.<sup>8</sup> Further, to be enforceable under the prior Georgia law, a restrictive covenant must specify with particularity the nature of the prohibited business.<sup>9</sup> A vague prohibition against participating in a similar business is not sufficient. For these reasons, the court held that the franchise agreement’s post-term restrictive covenant was unenforceable due to its unreasonable scope restriction and granted partial summary judgment to the former franchisees.<sup>10</sup>

However, in light of recent legislative developments in Georgia, the hostility towards the enforcement of non-compete provisions in Georgia, illustrated by the *Fantastic Sams* decision and its progeny, appears to be coming to an end. Specifically, in 2009, the Georgia Legislature repealed the former Georgia Code Section 13-8-2.1 and attempted to provide for the enforcement of contracts that restrict or prohibit competition in certain commercial agreements. In its place is a new Article 4 of Chapter 8 of Title 13 that has been enacted with legislative findings that reasonable restrictive covenants contained in employment and commercial contracts serve a legitimate purpose of protecting legitimate business interests, and that statutory guidance is desirable so that all parties to such agreements may be certain of the validity and enforceability of such provisions and to know their rights and duties according to such provisions.<sup>11</sup>

This new legislation specifically states that restrictive covenants may exist within or ancillary to contracts between or among franchisors and franchisees, as well as employers and employees, distributors and manufacturers, lessors and lessees, partnerships and partners, employers and independent contractors, sellers and purchasers of a business or a commercial enterprise, and any two or more employers.<sup>12</sup> However, the new legislation only applies to agreements entered on or after the effective date of the legislation, November 2, 2010.<sup>13</sup> While the statute makes plain the Georgia legislature’s intent to construe covenants not to compete in a more liberal fashion, how the Georgia Courts will actually construe the new legislation remains to be seen.

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<sup>7</sup> 2012 WL 210889, at \*2 (citing *Atlanta Bread Co., Int’l*, 679 So. 2d at 723).

<sup>8</sup> *Id.* at \*3.

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> O.C.G.A. § 13-8-50 et. seq.

<sup>12</sup> O.C.G.A. § 13-8-52(a).

<sup>13</sup> See *Fantastic Sams Salons Corp.*, 2012 WL 210889, at \*2 n.1 (citing O.C.G.A. § 13-8-54, historical and statutory notes).

**B. What Constitutes a Protectable Interest of a Franchisor for Purposes of Covenants Against Competition?**

Franchisors have varied interests in having and enforcing covenants not to compete. Those interests include protection of the franchisor's goodwill;<sup>14</sup> protection of the franchisor's confidential business information and trade secrets;<sup>15</sup> protection of the franchisor's specialized operating methods and training;<sup>16</sup> and protection of the system by ensuring franchisee loyalty to the system and protecting current franchisees.<sup>17</sup> Courts routinely protect those interests.

When enforcement of the covenant not to compete against the franchisee is in-term as opposed to post-term the protectable business interests are typically greater. For example, when a franchisee violates an in-term covenant not to compete, the franchisor is exposed to having its confidential business information and trade secrets pirated for use in the competing location. Likewise, violation of in-term covenants not to compete damages franchisee loyalty to the system and exposes those other franchisees to potential harm. If the public misperceives the unauthorized competing unit as a franchised location and the services are subpar, the damage to the good will of the system likewise damages the other franchisees. Similarly, if other franchisees are aware of a franchisee who is allowed to violate the in-term covenant not to compete, there is no incentive for the franchisees to refrain from such action and protect the confidential information on which the system is based even while they are benefitting from the goodwill of the system and the confidential information on which the system is based.

When the covenant not to compete is violated post-term, however, the franchisor's interests in having the covenant not to compete enforced are equally strong, but are weighed against the former franchisee's interest in procuring a livelihood and providing for the public good.<sup>18</sup> Thus, courts generally require that post-term covenants not to compete be reasonable as to time, geography and scope.<sup>19</sup>

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<sup>14</sup> See *Singas Famous Pizza Brands Corp. v. New York Advertising LLC*, 2012 WL 899231, at \*3 (2d Cir. March 19, 2012) (enforcing non-compete covenant protects damage to franchisor's good will); *Curves Int'l, Inc. v. Szostek*, Bus. Franchise Guide (CCH) ¶ 14,671 (N.D. Ill. June 6, 2011) (non-compete agreement protects franchisor's business interests of protecting goodwill attendant with franchisor's trademarks); *Larzak, Inc. v. Tutor Time Learning Ctrs., LLC*, 2007 WL 2025214, at \*11 (N.D. Ind. July 6, 2007) (franchisor has a protectable interest in the goodwill developed between customers and the business); *Am. Express Financial Advisors, Inc. v. Yantis*, 358 F. Supp. 2d 818, 829 (N.D. Iowa 2005) (non-compete covenant necessary to protect business and good will).

<sup>15</sup> See, e.g., *Certified Restoration Dry Cleaning, Network, LLC v. Tenke Corp.*, 511 F. 3d 535, 548 (6th Cir. 2007) (covenants not to compete may protect business interests such as trade secrets, confidential information and customer lists); *Tutor Time*, 2007 WL 2025214, at \*11 (protectable interest of business includes secret or confidential information such as the customer lists, methods of operation, manuals and other materials used to operate a franchise location).

<sup>16</sup> See *Tutor Time*, 2007 WL 2025214, at \*11 (franchisor established legitimate protectable interest in specialized operating methods and training associated with system).

<sup>17</sup> See, e.g., *Curves Int'l.*, Bus. Franchise Guide (CCH) ¶ 14,671 (non-compete agreement protects the integrity of the system and protects ability of franchisor to re-franchise the area); *NaturaLawn of Am., Inc. v. West Group, LLC*, 484 F. Supp. 2d 392, 402 (D. Md. 2007) (franchisor would be permanently damaged and permanently shut out of market if covenant not enforced because few if any prospective franchisee would agree to step in the relevant market if former franchisee were not enjoined from violating covenant not to compete).

<sup>18</sup> See, e.g., *Atlanta Bread Co., Inc. v. Lupton-Smith*, 679 S.E. 2d 722, 724 (Ga. 2009) (quoting *Rakestraw v. Lanier*, 30 S.E. 735 (Ga. 1898), *superseded by statute*, Ga. Code Ann. § 13-8-50 *et. seq.* (2012) ("Contracts in unreasonable restraint of trade are contrary to public policy and void, because they tend to injure the parties making them, diminish their means of procuring livelihoods and a competency for their families; tempt improvident persons, for the sake of present gain, to deprive themselves of the power to make future acquisitions, and expose them to



Courts have relied on language in franchise agreements where franchisees acknowledge the importance of the franchisor's business interests in having its covenant not to compete enforced. For example, one court found as a basis for enforcing a covenant not to compete that "[the franchisee] acknowledged that [the franchisor] possessed certain confidential information regarding ways of doing business which gave franchisees a competitive advantage" and that the franchisee agreed to the covenant not to compete in exchange for the use of that confidential information and the valuable property interest of the franchisor's trademarks.<sup>20</sup> Thus, in drafting covenants not to compete for franchise agreements, practitioners may want to set forth the business interests being protected and have the franchisee acknowledge the franchisor's business interests in the franchise agreement.

## **C. What Parameters of Duration and Geographic Scope are Enforceable?**

### **1. Standards of Performance**

#### **a. In-Term Standards vs. Post-Term Standards**

In assessing non-compete covenants in the franchise context, it is imperative to differentiate between those covenants that are in-term versus those that are post-term. As set forth above, an in-term covenant provides that the franchisee will not compete with the franchisor (or other franchisees) during the term of the franchise agreement, while a post-term covenant prohibits the franchisee from competing against the franchisor for a period of time after the termination or expiration of the parties' franchise agreement. Often times, post-term covenants will contain geographic restrictions on the franchisee's ability to compete against the franchisor within a specific radius or distance from the former franchised location(s).

In general, the purpose of these non-compete covenants is to protect a franchisor's intellectual property, trade secrets (*i.e.* operating manual and other confidential materials) and overall investment in the franchise system. In addition, both in-term and post-term covenants serve unique and specific purposes. For example, in-term covenants are utilized in order to protect the franchisor from the franchisee becoming disloyal to the brand by using the knowledge gained from a franchisor's business model and system to open another competing entity, thereby reaping the benefits of the franchisor's expertise while still a part of the system. Post-term covenants are used mainly to protect the franchisor's interest in the goodwill and name recognition built up at a particular location or in a particular community.

Reasonableness is the key consideration courts look to in assessing non-competition covenants, because these covenants are viewed as restraints of trade and some states have enacted statutes that prohibit restrictive covenants. Whether or not a particular covenant's restrictions (geographic, time, scope) are reasonable is usually a question of law that can be decided by the court. However, as the following decisions illustrate, these determinations are fact-specific and can be highly unpredictable. Indeed, successfully obtaining the enforcement of non-competition provisions requires that the franchisor carefully consider several factors.

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imposition and oppression; tend to deprive the public of services of [people] in the employments and capacities in which they may be most useful to the community as well as themselves; discourage industry and enterprise, and diminish the products of ingenuity and skill; prevent competition and enhance prices, and expose the public to all the evils of monopoly").

<sup>19</sup> *Id.*

<sup>20</sup> *Curves Intl.*, Bus. Franchise Guide (CCH) ¶ 14,671 (N.D. Ill. June 6, 2011).

## b. In-Term Standards

By and large, in-term covenants against competition are used to protect both the franchisor and other franchisees in the system from the unapproved movement of proprietary information to competitors, as well as to ensure that the franchisee devotes sufficient energy and loyalty to the franchise brand. These covenants are generally upheld if they are reasonable as to the scope of restricted activity, geography, as well as time.

Courts appear to view in-term covenants with less skepticism and scrutiny than post-term covenants, given that such covenants serve to protect the legitimate interest of the franchisor in compelling the devotion of best efforts.<sup>21</sup> An excellent illustration of this can be seen under California law, where post-term covenants are generally not enforceable. However, in *Shaklee U.S. Inc. v. Giddens*, the Ninth Circuit upheld the validity of in-term covenants prohibiting current employees from competing against their employers, holding that this principle also applies to supplier-distributor relationships and was not in contravention of California law.<sup>22</sup>

Still, as two 2010 decisions by the same judge in Minnesota show, whether or not an in-term non-compete provision will be enforced -- usually through injunctive relief -- is not a mechanical exercise and depends on the facts of each case. In one case, the judge ruled that a temporary restraining order was not warranted as the franchisor, a fitness franchisor, failed to show irreparable harm through unfair competition.<sup>23</sup> In so holding, the judge found that the alleged harms from the franchisee's violation of an in-term non-compete agreement were "speculative" rather than certain and imminent. The franchisee had converted its prior franchise facility into a non-franchise facility post-expiration. The court reasoned that irreparable harm was speculative, because if the franchisee used any proprietary information, he would be primarily competing with his own business as he still owned the nearest franchise to his non-franchise facility. The court made this ruling even though it specifically found that the franchisor had a legitimate interest in protecting itself from unfair competition.

Standing in contrast is the same judge's decision in *Bonus of America, Inc. v. Angel Falls Services, L.L.C.*<sup>24</sup> There, in a case involving a building cleaning and maintenance franchise, the court found that the evidence suggested that the franchisee's operation of a second, similar business violated in-term non-compete clauses that were enforceable under Texas law, indicating that the franchisor was likely to succeed on the merits of its contract claims. A preliminary injunction was therefore issued against the second business to prevent it from taking the franchised unit's business and from using the franchisor's trademarks. The second business used many of the same employees and independent contractors as the franchised unit, some of the proposals of the competing business listed the franchisee as its contact, and there was evidence that the second business had used the franchise's name in its email to conduct its affairs. These specific facts were in direct contrast to *Anytime Fitness*, where the evidence showed that the franchisee instructed his employees to inform customers that there was no affiliation with the franchisor.<sup>25</sup>

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<sup>21</sup> See *Major v. Orthopedic Equipment Co.*, 496 F. Supp. 604 (E.D. Va. 1980).

<sup>22</sup> 934 F.2d 324 (9th Cir. 1991).

<sup>23</sup> *Anytime Fitness, Inc. v. Family Fitness of Royal, LLC*, 2010 WL 145259 (D. Minn. Jan. 8, 2010).

<sup>24</sup> 2010 WL 2734218 (D. Minn. Jul. 6, 2010).

<sup>25</sup> *Anytime Fitness, Inc.*, 2010 WL 145259 at \*2.

### **i. Scope of Restricted Activity**

For in-term covenants, the scope of activities restricted in a typical franchise agreement provision may include: (1) owning, operating, being employed by or providing assistance to any business that is competing or similar to the franchised business and/or (2) requiring that the franchisee spend full-time on or devote best efforts to the system.

The lack of a time limit or scope in in-term covenants is not unreasonable on its face, because the covenant is inherently limited to the term of the franchise agreement. Nevertheless, an in-term covenant not to compete in a franchise agreement will not be enforced if it prevents competition in a substantial share of a business, trade or market. For example, as the Ninth Circuit decided in *Comedy Club, Inc. v. Improv West Associates*, an in-term covenant that would have prohibited a franchisee from doing business anywhere in the United States for 14 years was unenforceable as a matter of law, and an arbitrator's award enforcing such a covenant was vacated for exceeding his authority.<sup>26</sup>

### **ii. Geographic Restrictions**

With respect to geographic restrictions, in-term non-compete provisions usually contain broad territorial limits, if any, that often exceed the franchisor's operational territory. This is so because franchisors do not want to limit their ability to grow the brand in the future -- especially considering many franchise agreements run for 5, 10 or even 20 years. The fact that a franchisor does not have a footprint in a specific area at the time the franchise agreement is entered may not hold true should the franchisor expand in the future. As such, franchisors often seek protection vis-à-vis in-term non-compete provisions, which protect them from competition from their own franchisees everywhere.

While courts have been known to deem such provisions with no territorial limit unenforceable, even if it is an in-term non-compete,<sup>27</sup> other courts have enforced the clauses to the extent that they were reasonable whether or not there was a geographical limit.<sup>28</sup> On the extreme end of the spectrum on this issue is Illinois, where, as a matter of law, a covenant cannot be challenged during the term of the franchise.<sup>29</sup> As discussed above, even California enforces in-term covenants not to compete, despite that post-term covenants not to compete are generally not enforceable in the state.

### **c. Post-Term Covenants Against Competition**

Post-term covenants against competition present more difficult questions for the courts than in-term covenants for a number of reasons. First, since these provisions necessarily come into play at the conclusion of the franchise relationship, the franchisee will often plead that it will

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<sup>26</sup> 553 F.3d 1277 (9th Cir. 2009).

<sup>27</sup> See e.g., *Kutka v. Temporaries, Inc.*, 568 F. Supp. 1527 (S.D. Tex. 1983).

<sup>28</sup> See e.g., *Keating v. Baskin-Robbins USA, Co.*, 2001 WL 407017 (E.D.N.C. Mar. 21, 2001); see also *Deutschland Enterprises, Ltd. v. Burger King Corp.*, 957 F.2d 449, 452-53 (7th Cir. 1992) (affirming district court ruling enforcing in-term covenant not to compete with no geographical limitation); *Adcom Express, Inc. v. EPK, Inc.*, 1996 WL 266412 (Minn. Ct. App. May 21, 1996); *McDonald's System Inc., v. Sandy's, Inc.*, 195 N.E. 2d 22 (Ill. App. Ct. 1963) (territory is not a factor in determining the validity of an in-term covenant).

<sup>29</sup> *McDonald's System Inc.*, 195 N.E. 2d at 31.

have no means of livelihood if the post-term covenant is enforced. Such pleas can be particularly persuasive when the franchise agreement has had a long duration or if the circumstances of termination appear inequitable. Also, because the franchisee is no longer part of the system, a franchisor's interests in enforcement are not as pressing as with respect to in-term covenants. Still, the majority of courts will respect the parties' right to contract as they see fit and will enforce these post-term covenants not to compete to the extent that they are reasonable.

In evaluating post-term non-compete provisions, most courts analyze these covenants under a four-pronged test for reasonableness. In sum, the covenant must: (1) be ancillary to an otherwise lawful contract; (2) be no greater than required to protect the franchisor's legitimate business interest; (3) be reasonable and not impose undue hardship on the franchisee; and (4) not be adverse to the public interest.<sup>30</sup>

#### **i. Standard for Evaluation of Post-Term Covenants**

In order to properly analyze the reasonableness of a post-term non-compete provision, a court first needs to decide the appropriate standard of review for these provisions. Some courts choose to make an initial finding of whether to treat the post-term non-compete provision similar to one contained in an employment agreement or one ancillary to the sale of a business.<sup>31</sup>

Many states simply use a general reasonableness standard. For instance, under New York law, a restrictive covenant is "rigorously examined" and only enforced if it is reasonable in terms of its time, space or scope and not oppressive.<sup>32</sup> Applying these reasonableness principles, in *Singas Famous Pizza Brands Corp. v. New York Advertising LLC*,<sup>33</sup> the Second Circuit recently held that a ten-mile geographic scope of franchise agreement's post-termination non-compete clause was reasonably calculated toward furthering the franchise owner's legitimate interests in protecting its knowledge and reputation as well as its customer good will.

In *Singas*, the former franchisee expressly acknowledged in its agreement that a ten-mile geographic restriction was "fair and reasonable," thus undermining the former franchisee's argument that such a restriction was too broad due to the local nature of pizza businesses. The franchisor argued that such a restriction was reasonable and necessary for the protection of the franchisor's proprietary interest and that the violation of this restriction would cause substantial and irreparable injury to the owners of the other franchised pizza restaurants.

Further, the Second Circuit noted that the danger posed to the franchisor's institutional know-how, reputation and goodwill by the continued operation of the former franchise restaurant was readily apparent as the competing restaurant used a menu that was virtually identical to that of the franchise system, adopted certain distinctive practices associated with the franchise system, employed at least some of the same personnel as the franchised location and used

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<sup>30</sup> See e.g., *Jiffy Lube Int'l, Inc. v. Weiss Bros., Inc.*, 834 F. Supp. 683 (D.N.J. 1993).

<sup>31</sup> See e.g., *H&R Block Tax Services v. Circle A Ent., Inc.*, 693 N.W. 2d 548 (Neb. 2005).

<sup>32</sup> *Am. Inst. Chem. Eng'rs v. Reber-Friel Co.*, 682 F. 2d 382, 387 (2d Cir. 1982); see also, e.g., *Ticor Title Ins. Co. v. Cohen*, 173 F. 3d 63, 69 (2d Cir. 1999) (finding in the employment contracting context that "[t]he issue of whether a restrictive covenant not to compete is enforceable by way of an injunction depends in the first place upon whether the covenant is reasonable in time and geographic area" weighing "the need to protect the employer's legitimate business interests against the employee's concern regarding the possible loss of livelihood").

<sup>33</sup> 2012 WL 899231 (2d Cir. Mar. 19, 2012).

certain custom-made equipment taken from the franchise.

Likewise, in *Meineke Car Care Centers, Inc. v. Bica*,<sup>34</sup> a federal court in North Carolina used a general reasonableness standard and held that a post-term covenant not to compete is valid in North Carolina if it is reasonably necessary to protect the legitimate interest of the person seeking enforcement, reasonable with respect to time and territory and does not interfere with the interest of the public. The court found that these elements were satisfied. Meineke had expended substantial resources developing its processes, manuals, advertising materials, building goodwill and obtaining a national reputation as a provider of automotive services. The court reasoned that a franchisee should not be permitted to learn a system and then use that confidential and proprietary information acquired from the system to take business away from the system upon termination. Further, the covenant at issue was merely a one-year restriction and found to be reasonable.

## ii. Scope of Restricted Activity

As noted above, while different courts may employ different standards in determining the reasonableness of post-term non-compete provisions, they still must be no more restrictive than reasonably necessary to protect activities such as the franchisor's legitimate business interests, which includes goodwill, confidential information and financial well-being, as well as overall competitive fairness.<sup>35</sup>

Some types of restrictions, which are routinely found to be reasonable in scope and therefore enforceable are: (1) restrictions on using a franchisor's trademarks or products;<sup>36</sup> (2) restrictions on soliciting customers of the franchisor,<sup>37</sup> and; (3) restrictions on hiring away employees of the franchisor.<sup>38</sup>

Restrictions with regard to operating certain types of businesses are also enforceable.<sup>39</sup> For example, in *NaturaLawn of Am., Inc. v. West Group, LLC*, the court held that the scope of a post-termination covenant not to compete was reasonable when it restricts operation of "the same type of business that the defendants operated as franchisees."<sup>40</sup> However, provisions concerning the type of business can be a slippery slope, as courts will often decline

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<sup>34</sup> 2011 WL 4829420 (W.D.N.C. Oct. 12, 2011).

<sup>35</sup> See e.g., *Novus Franchising, Inc. v. Oksendahl*, 2007 WL 2084143, at \*3 (D. Minn. Jul. 17, 2007) (no dispute that franchisor has legitimate interest in protecting itself from unfair competition and in ensuring the financial well-being of its franchise network, as well as legitimate business interest in protecting the goodwill that is associated with their trademarks and products); *Bennigan's Franchising Co. v. Swigonski*, 2007 WL 603370 (N.D. Tex. Feb. 27, 2007) (non-compete provision that applied to "any casual dining or other restaurant business" was overly broad because there was no definition in the franchise agreement of the term "casual dining restaurant" and there was conflicting testimony on the issue in court).

<sup>36</sup> *Id.*

<sup>37</sup> *Merry Maids L.P. v. Kamara*, 33 F. Supp. 2d 443 (D. Md. 1998) (finding that a one year, 75-mile non-compete provision reasonable).

<sup>38</sup> *Id.*

<sup>39</sup> See e.g., *NaturaLawn of Am., Inc. v. West Group, LLC*, 484 F. Supp. 2d 392 (D. Md. 2007) (upholding scope of covenant not to compete of same type of business that was operated while a franchisee).

<sup>40</sup> *Id.* at 399-400.

enforcement of the provision where the wording is vague or overly broad.<sup>41</sup>

### iii. Geographic Restrictions

With respect to geographic restrictions, there is no one-size-fits-all rule as far as what distance is enforceable. Courts look at the nature of the business and the type of protection needed in connection with the distance in determining reasonableness. Again, the axiom of “no greater than necessary” holds true as courts are more likely to enforce provisions that are narrowly tailored to, for example, a radius around the former franchisee’s location, rather than a blanket restriction around any franchise location.

An example of this can be found in *Boulangier v. Dunkin’ Donuts Inc.*,<sup>42</sup> where the Supreme Judicial Court of Massachusetts upheld a post-termination non-compete provision, which precluded a former franchise owner from working for a competitor of Dunkin’ Donuts within five miles of any other franchise as being reasonable even though Dunkin’ Donuts owned 704 stores in Massachusetts and 122 in New Hampshire. The court did so, because the covenant did not prohibit employment altogether. The former owner was not prohibited from working at another franchise store in a different capacity during the covenant’s duration and the covenant was designed to preserve the franchise system and prevent the former owner from using confidential information to harm Dunkin’ Donuts franchisees in other locations.

Further, the court in *Meineke Car Care Centers, Inc. v. Bica* also held that a six-mile radius restriction from the current location operated by the franchisee or six miles from any other Meineke location in existence at the time the agreement was terminated was reasonable, because North Carolina enforced national territory restrictions and covenants not to compete when the plaintiff company did business nationally.<sup>43</sup>

Likewise, in *Carvel Corp. v. Eisenberg*,<sup>44</sup> a judge in the Southern District of New York ruled that a restrictive covenant limiting the franchisee defendants’ ability to operate an ice cream store within two miles of their present location in Dade County, Florida for three years following the termination of the franchise agreement was reasonably related to Carvel’s legitimate interest in protecting its know-how and its ability to install another franchisee in the same territory. Notably, the franchisee in *Carvel Corp.* unsuccessfully argued the restrictive covenant was an illegal restraint on trade under both the Sherman Antitrust Act<sup>45</sup> and its New York counterpart, the Donnelly Act,<sup>46</sup> which was summarily rejected by the court.

However, in *Maxon v. Franklin Traffic Serv., Inc.*,<sup>47</sup> the court ruled the geographic scope

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<sup>41</sup> See e.g., *Novus Franchising, Inc.*, 2007 WL 2084143 at \*3 (franchisor’s construction of non-compete provision overly broad in that it would extend protection to products and services that do not involve the franchisor’s marks and products).

<sup>42</sup> 815 N.E.2d 572 (Mass. 2004).

<sup>43</sup> 2011 WL 4829420 at \*5.

<sup>44</sup> 692 F. Supp. 182 (S.D.N.Y. 1988).

<sup>45</sup> 15 U.S.C. § 1, *et seq.*

<sup>46</sup> N.Y. G.B.L. § 340.

<sup>47</sup> 261 A.D.2d 830 (N.Y. App. Div. 1999).

of the covenant not to compete to be unreasonable where the former franchisee, a shipping company, was restrained from competing within 300 miles of any franchisee in the system. This restriction was deemed unduly burdensome.<sup>48</sup>

#### iv. Time Restrictions

In assessing the validity of a time restriction contained in a post-termination covenant, and determining its reasonableness, courts will often look at how long it will take to re-franchise a given territory. For example, in *Maaco Franchising, Inc. v. Augustin*, the court noted that given the time needed to bring a franchise up to speed and to protect the franchisor's interests, a one-year term was reasonable.<sup>49</sup> Courts generally find post-termination time restrictions of two years or fewer to be reasonable.<sup>50</sup> It is worth noting that while these post-termination covenants generally begin to run from the date of termination or expiration, some courts will often extend these periods to begin running from the date of an injunction enforcing these provisions in order to give the franchisor the full benefit of the provision.<sup>51</sup>

### 2. Court Modification of Covenants Against Competition

#### a. Blue Pencil

A court, when confronted with an otherwise unenforceable non-competition covenant, may utilize the so-called "blue pencil" rule and modify the covenant by reducing it to what the court considers reasonable. In general, courts only modify the scope, time and geography restrictions, so long as they do not effectively rewrite the contract.<sup>52</sup>

For example, the Supreme Court of Arizona has said "[although they] will not permit courts to add terms or rewrite provisions to covenants ... Arizona courts will 'blue pencil' restrictive covenants, eliminating grammatically severable, unreasonable provisions."<sup>53</sup> Indiana courts also allow blue-penciling; their "doctrine permits excising language but not rewriting the agreement."<sup>54</sup>

Some states simply strike unreasonable covenants against competition entirely. The Supreme Court of Wisconsin has adopted this approach, saying "[under Wisconsin's] blue-

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<sup>48</sup> *Id.* at 832.

<sup>49</sup> 2010 WL 1644278, (E.D. Pa. Apr. 20, 2010).

<sup>50</sup> See e.g., *Rita's Water Ice Franchise Co. v. S.A. Smith Enters., LLC*, 2011 WL 101694, at \*7 (E.D. Pa. Jan. 11, 2011) (holding that a two-year non-compete covenant was reasonable); *Athlete Foot's Mktg. Assocs. v. Zell Inv., Inc.*, 2000 WL 426186, at \*11 (W.D. Pa. Feb. 17, 2000) (one-year covenant "clearly reasonable" under Pennsylvania law).

<sup>51</sup> See e.g., *Thermatool Corp. v. Borzym*, 575 N.W.2d 334 (Mich. Ct. App. 1998) (court may extend a covenant not to compete beyond its stated expiration date as an appropriate remedy for a breach of the agreement).

<sup>52</sup> See e.g., *Bayly, Martin & Fay, Inc. v. Pickard*, 780 P.2d 1168, 1173 (Okla. 1989) (judicial modification of a covenant not to compete is justified if the contractual defect can be cured through reasonable limitations concerning the activities embraced, time or geographical limitations, but not if essential elements of a contract must be supplied).

<sup>53</sup> *Fearnow v. Ridenour, Swenson, Cleere & Evans, P.C.*, 138 P.3d 723, 731 (Ariz. 2006).

<sup>54</sup> *Cent. Indiana Podiatry, P.C. v. Krueger*, 882 N.E.2d 723, 730 (Ind. 2008).

pencil rule ... the whole covenant [is] void if any part of the restriction [is] unreasonable.”<sup>55</sup>

In one case, applying New Jersey law, the court in *Jiffy Lube* “blue-penciled” a restrictive covenant with a radius of 10 miles and a duration of three years and reduced it to a radius of 5 miles, reasoning that the type of business involved (a rapid-lubrication service), was one in which most customers would stay close to their homes or workplaces in deciding where to service their vehicles.<sup>56</sup> Similarly, the court in *Hometask Handyman Services, Inc. v. Cooper*,<sup>57</sup> enforced a post-termination non-compete against a former franchisee through application of the blue-pencil rule to reduce a radius of 100 miles to 25 miles, because 100 miles was unreasonable.

Some courts, however, will not apply the blue pencil rule when to do so would re-write the parties’ agreements and encourage franchisors to fashion aggressive covenants with the knowledge that courts will simply reduce them for the covenants to become enforceable.<sup>58</sup>

#### **b. Severance**

Alternatively, some courts will only resort to the blue-pencil rule where the non-compete covenant is clearly severable into parts and some of the terms of the covenant are reasonable.<sup>59</sup> The contract may be held divisible, and the reasonable restrictions may be enforced.<sup>60</sup>

#### **D. Interplay Between Covenants and Non-Solicitation Agreements**

Many franchisors are including non-solicitation clauses in their franchise agreements, in addition to traditional covenants against competition. Non-solicitation clauses may prohibit a former franchisee from soliciting employees of the franchisor or other franchisees, or the clause may prohibit the solicitation of customers or clients. Generally, non-solicitation clauses, standing alone, are less restrictive than a covenant against competition clause, which seeks to prohibit a franchisee from any competition in the marketplace whatsoever. Non-solicitation clauses are specifically targeted to prevent franchisees from raiding employees or diverting customers, or both. Even if subject to a non-solicitation clause, a franchisee without a non-compete could continue in the same trade or business, could work for a competitor, could accept business from a former customer who reaches out to the franchisee, and could solicit customers who never had dealings with the business owner when he or she was a franchisee. This is relative post-termination freedom for former franchisees.

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<sup>55</sup> *Star Direct, Inc. v. Dal Pra*, 767 N.W.2d 898, 915 (Wisc. 2009); see also *Better Living Components, Inc. v. Coleman*, 67 Va. Cir. 221 (2005) (holding that Virginia courts will not “blue pencil” a contract to make it enforceable).

<sup>56</sup> *Jiffy Lube Int’l, Inc. v. Weiss Bros., Inc.*, 834 F. Supp. 683, 692 (D.N.J. 1993).

<sup>57</sup> 2007 WL 3228459 (W.D. Wash. Oct. 30, 2007).

<sup>58</sup> See e.g., *Richard P. Rita Personnel Servs. Int’l, Inc. v. Kot*, 191 S.E.2d 79 (Ga. 1972).

<sup>59</sup> See *South Bend Consumers Club, Inc. v. United Consumers Club, Inc.*, 572 F. Supp. 209, 214-15 (N.D. Ind. 1983) (blue-penciling can only be used where the covenant is “clearly separated into parts with some parts being reasonable and others clearly not meeting that standard”).

<sup>60</sup> *Licocci v. Cardinal Assoc., Inc.*, 445 N.E.2d 556 (Ind. 1983) (trial court’s enforcement of some, but not all, of the restrictions was not in error when the covenant was separable into three distinct parts).



Few franchisors, however, limit their post-termination restrictions to a non-solicitation clause. Indeed, franchisors increasingly include both types of clauses, perhaps as a way of hedging their bets in the event the broader covenant against competition is found unenforceable. The various states treat non-solicitation clauses much the same way they treat non-competition clauses. Thus, California, which is known for its condemnation of covenants against competition, similarly disfavors non-solicitation clauses as anti-competitive.<sup>61</sup> In Georgia, where pre-2010 covenants against competition are still subject to strict scrutiny, non-solicitation clauses are subject to that same level of scrutiny as illustrated by *Dent Wizard Int'l Corp. v. Brown*.<sup>62</sup> In *Dent Wizard*, the court found the non-solicitation clause went beyond what was necessary to protect the franchisor's interest in its customers where it prohibited the former franchisee from engaging in the franchised business with anyone in the territory. According to the court, "where the restriction is broad – for example, not limited to clients the employee served – the territorial limitation must be specified and closely tied to the area in which the employee actually worked."<sup>63</sup> In *Smallbizpros, Inc. v. Court*, a federal district court in Georgia enforced a non-solicitation clause where it applied only to previous customers.<sup>64</sup> The court found that the restrictions were reasonable because they did not "altogether prevent defendants from doing accounting work within the franchise area or from accepting unsolicited business from forbidden customers."<sup>65</sup>

Although the typical non-compete clause and the typical non-solicitation clause have differing purposes and differing scope, courts often analyze them together. For example, in *JTH Tax, Inc. v. Donofrio*, the court enjoined a former tax preparer franchisee from soliciting former clients.<sup>66</sup> According to the court, defendant's continued breach of her non-compete and non-solicitation obligations presented plaintiff with a high likelihood of permanent loss of former and potential customers justifying an injunction.<sup>67</sup> Similarly, a franchisor obtained an injunction against a former staffing franchisee's solicitation of past or future temporary employees in *DAR & Associates, Inc. v. Uniforce Services, Inc.* after the court found both the non-compete and non-solicitation clauses to be reasonable in scope and duration.<sup>68</sup> The court balanced the competing public policies in favor of competition and freedom of contract and determined that any hardship caused by enforcement of the restrictive covenants was ameliorated by the fact that the franchisee had accepted that outcome when it entered into the agreements.<sup>69</sup>

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<sup>61</sup> See *Dowell v. Biosense Webster, Inc. and American Credit Indemnity Co. v. Sacks*, *infra*.

<sup>62</sup> 612 S.E.2d 873, 876 (Ga. Ct. App. 2005).

<sup>63</sup> *Id.*

<sup>64</sup> 414 F. Supp. 2d 1245, 1250 (M.D. Ga. 2006).

<sup>65</sup> *Id.*

<sup>66</sup> 2006 WL 2796841 (E.D. Va. Sept. 26, 2006).

<sup>67</sup> *Id.*

<sup>68</sup> 37 F. Supp. 2d 192, 200 (E.D.N.Y. 1999).

<sup>69</sup> *Id.*

**E. Whether Non-Signatories to a Franchise Agreement May be Subject to the Covenant Against Competition in the Agreement**

As is evident by this paper, whether a covenant not to compete will be enforced against a non-signatory to a franchise agreement depends in large part upon the state law that applies to the matter. However, states that would enforce a covenant not to compete against a party to an agreement are hesitant to allow that party to do an end-run around the covenant not to compete by operating a competing business through a relative, employee, affiliate or the like. In such circumstances a non-signatory to a franchise agreement may be subject to a covenant not to compete contained in a franchise agreement where the non-signatory in effect is assisting the former franchisee to violate the covenant not to compete.<sup>70</sup>

For example, in *JTH Tax, Inc. v. Lee*,<sup>71</sup> the court was asked to enforce a preliminary injunction against the non-signatory wife, who continued to operate a tax business within the territory that the husband formerly maintained the franchise and within the area that the court had enjoined the husband from competing. The court had issued an injunction enjoining the husband and “all of his agents, employees, and all other persons in active concert or participation with him” from preparing or electronically filing income tax returns within the former territory of the franchisee or within twenty-five miles thereof.<sup>72</sup> Notwithstanding the order, the wife took over the same lease for the same building as the former franchisee, retained the customer files, used the same phone numbers, and had even recruited former customers as her customers at the competing business.<sup>73</sup> Under those facts and circumstances and pursuant to Rule 65 of the Federal Rules of Civil Procedure, the court not only enforced the covenant not to compete against the wife of the former franchisee, but also ordered that if she did not comply with the court’s order within 10 days she would be fined \$500 per day until she came into compliance.<sup>74</sup>

Likewise, in *Gold Messenger, Inc. v. McGuay*,<sup>75</sup> the life partner of the former franchisee of an advertising circular argued that the covenant not to compete in the franchise agreement between the franchisor and the former franchisee could not be extended to him, because he had not signed the franchise agreement.<sup>76</sup> The franchise agreement contained a covenant not to compete prohibiting a terminated franchisee from competing with the franchisor for a period of 3 years from the date of termination and within fifty miles of any of the franchisor’s franchised territories.<sup>77</sup> The franchisor terminated the franchise agreement, because the franchisee failed to pay royalty fees, and about the same time, the partner of the former franchisee began

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<sup>70</sup> See *Gold Messenger, Inc. v. McGuay*, 937 P.2d 907, 912 (Colo. App. 1997) (third party non-signatory is bound to a covenant not to compete at least to the extent that the third party assists the covenanter to violate the covenant not to compete).

<sup>71</sup> 540 F.Supp. 2d 642 (2007).

<sup>72</sup> *Id.* at 647.

<sup>73</sup> *Id.* at 648.

<sup>74</sup> *Id.*

<sup>75</sup> 937 P.2d 907 (Colo. App. 1997).

<sup>76</sup> *Id.* at 908.

<sup>77</sup> *Id.* at 909.

operating a competing advertising circular in the same general territory of the former franchise territory.<sup>78</sup> In enforcing the covenant not to compete against the non-signatory partner of the former franchisee, the court found that the covenant could be applied to the non-signatory, because a third party is bound by a covenant not to compete where he is aiding the signatory to violate the covenant.<sup>79</sup> In so holding, the court found that the partners had operated the franchise together for at least 2 years; they were both trained by the franchisor; they both attended regular meetings; and they both read the confidential manual.<sup>80</sup> Further, after termination of the franchise agreement, the partners started to operate the competing advertising circular, although this time the non-signatory was now the owner of record.<sup>81</sup> Given the facts, the court found that the non-signatory must be prohibited from acting in concert with the former franchisee to breach the post-termination covenants in the franchise agreement and from misappropriating the franchisor's trade secrets.<sup>82</sup>

Courts have also enforced covenants not to compete against employees under certain circumstances. For example, in *H & R Block Tax Services, Inc. v. Peshel*, the court enforced a covenant not to compete, non-solicitation and non-disclosure provision against the former franchisee.<sup>83</sup> The court also, without much comment, enforced the covenant not to compete against employees of the franchisee, because the franchise agreement required the franchisee to obtain similar non-solicitation, non-compete, and non-disclosure provisions from her employees.<sup>84</sup> While the employees might also be enjoined under Rule 65's application to "agents, servants, employees and all others in active concert or participation with them," this case was plainly made easier for the court to decide by the inclusion of the language in the franchise agreement requiring the franchisee to obtain similar non-solicitation, non-compete, and non-disclosure provisions from her employees.

## **F. Defenses to Enforceability of Covenants Against Competition**

### **1. Over Breadth of the Covenant's Scope or Duration**

Franchisees may defend against covenants against competition if they are overly broad in geographic scope and/or duration.<sup>85</sup> Generally, courts will only enforce a covenant against competition in a franchise agreement if it is reasonable in terms of scope and duration.<sup>86</sup> In

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<sup>78</sup> *Id.*

<sup>79</sup> *Id.* at 912.

<sup>80</sup> *Id.*

<sup>81</sup> *Id.*

<sup>82</sup> *Id.*

<sup>83</sup> See *H & R Block Tax Services, Inc. v. Peshel*, 2005 WL 361493 (D. Minn. Feb. 16, 2005).

<sup>84</sup> *Id.* at \*4.

<sup>85</sup> *Atlanta Bread Co. Int'l, Inc. v. Lupton-Smith*, 663 S.E.2d 743, 747 (Ga. Ct. App. 2008) (finding that overly broad covenants against competition will not be enforced).

<sup>86</sup> *H & R Block Tax Services, Inc. v. Circle A Enterprises, Inc.*, 693 N.W. 2d 548, 549-50 (Neb. 2005) (a covenant not to compete ancillary to the sale of a business must be reasonable in both space and time so that it will be no greater than necessary to achieve its legitimate purpose. Whether such a covenant not to compete is reasonable with respect to its duration and scope is dependent upon the facts of each particular case).

determining reasonableness of a covenant's scope or duration, courts look to whether the limitations imposed are reasonably calculated to protect the legitimate interests of the franchisor.<sup>87</sup>

## **2. Franchisor's Material Breaches of Contracts**

Where the franchisor has committed a material breach of contract, some courts will not enforce non-competition clauses against the franchisee. In Michigan, such a breach by the franchisor nullifies the entire franchise agreement, including any covenants against competition.<sup>88</sup> In one case, a franchisor repeatedly failed to pay the franchisee's share of income, failed to administer payroll, and failed to manage employee health benefits as required by its franchise agreements. Subsequently, a franchisee unilaterally terminated the agreement and continued to operate its business.<sup>89</sup> A district court applying Michigan law denied the franchisor's motion for an injunction against the franchisee's continued operation based on Michigan law regarding contracts generally: "[h]e who commits the first substantial breach of a contract cannot maintain an action against the other contracting party for failure to perform."<sup>90</sup>

A material breach generally refers to a breach of the express terms of a franchise agreement. A Virginia court upheld a covenant against competition in a franchise agreement where the franchisees claimed material breach due to being "frustrated with [the franchisor's] management and performance under the franchise agreements," and the resultant "overall steady decline of the franchise system," from 100 franchisees in 1995 to only 26 in 2002.<sup>91</sup> The court upheld the covenant, finding that "deficiencies or failures to perform [to the satisfaction of the franchisees] on the part of [the franchisor] hardly go to the root of the franchise agreements...[as] such, the Court [declined] to impose additional contractual obligations on [the franchisor] that [were] not incorporated into the main body of the franchise agreement."<sup>92</sup>

Utah courts consider covenants against competition in franchise agreements unenforceable where the franchisor has materially breached the underlying franchise agreement. Utah courts ordinarily enforce covenants against competition where "[the] period of restraint [is] not unreasonable."<sup>93</sup> However, in a case before a Utah court of appeals, a franchisor attempted to enforce agreement even though the franchisor had breached the agreement by failing to calculate properly the franchisee's commissions. The court upheld a jury finding that "due to [the franchisor's] material breach of the Franchise Agreements, it was barred from enforcing the [noncompetition] provision."<sup>94</sup>

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<sup>87</sup> *Boulanger v. Dunkin' Donuts Inc.*, 815 N.E. 2d 572, 576-77 (Mass. 2004) (a covenant not to compete is enforceable only if it is necessary to protect a legitimate business interest).

<sup>88</sup> *P.A.L. Inv. Group, Inc. v. Staff-Builders, Inc.*, 118 F. Supp. 2d 781 (E.D. Mich. 2000).

<sup>89</sup> *Id.*

<sup>90</sup> *Id.* at 786.

<sup>91</sup> *Brenco Enterprises, Inc. v. Takeout Taxi Franchising Sys., Inc.*, 2003 WL 21659422 (Va. Cir. Ct. May 2, 2003).

<sup>92</sup> *Id.*

<sup>93</sup> *Pelton's Spudnuts v. Doane*, 234 P.2d 852, 855 (Utah 1951).

<sup>94</sup> *Holbrook v. Master Protection Corp.*, 883 P.2d 295, 300 (Utah Ct. App. 1994).

Georgia courts allow enforcement of non-competition covenants against franchisees where the franchisor has materially breached the franchise agreement. A Georgia court upheld a covenant against competition despite allegations of the franchisor's material breach of contract in terminating the agreement.<sup>95</sup> The court upheld the covenant because the covenant was reasonable and "provided for severability or survivability of the covenants from the franchise agreement...for any reason whatsoever...[and] must be enforced despite the possible breach of the underlying agreement by [the franchisor]."<sup>96</sup> The court in that case distinguished covenants against competition in franchise agreements from covenants against competition in employment contracts, saying "[since] this was not an employment agreement but a franchise agreement, then these covenants survive as independent covenants."<sup>97</sup>

### **3. Lack of Reciprocity of Restrictions**

Courts generally do not render void covenants against competition in franchise agreements due to a lack of reciprocity or mutuality of the restriction. While covenants against competition in franchise agreements must be supported by consideration,<sup>98</sup> such consideration need not result from a reciprocal restriction against the franchisor.<sup>99</sup>

Cases involving a 'lack of reciprocity' defense against a covenant against competition in a franchise agreement are rare. One Louisiana case addressed the enforceability of a covenant against competition that had a "lack of reciprocity...that is, [the franchisee] was prohibited from directly competing with [the franchisor] but [the franchisor] was not prohibited from setting up a competing business near [the franchisee]."<sup>100</sup> The court upheld the covenant, finding that reciprocity is "not as significant in a franchise relationship...as it would be in a partnership context, where its presence might indicate equality among the partners."<sup>101</sup> The court also noted that "[in] a franchise context, the fairness of the non-competition agreement...is more significant than the lack of reciprocity," fairness meaning reasonableness of the covenant.<sup>102</sup>

In a similarly argued case, a Virginia circuit court applying Florida law found that a franchisee "did not have a reciprocal right of cancellation [of the covenant against

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<sup>95</sup> *Zampatti v. Tradebank Int'l Franchising Corp.*, 508 S.E.2d 750 (Ga. Ct. App. 1998).

<sup>96</sup> *Id.* at 756.

<sup>97</sup> *Id.*

<sup>98</sup> 2 Franch & Distr Law & Prac § 8:49.

<sup>99</sup> *Bonus of America, Inc. v. Angel Falls Services, L.L.C.*, Bus. Franchise Guide (CCH) ¶ 14,415 (D. Minn. 2010) (finding that franchisee's allowed use of franchisor's business model and confidential information served as adequate consideration to support a post-term covenant against competition); see also *Meineke Discount Muffler Shops, Inc. v. Jaynes*, Bus. Franchise Guide (CCH) ¶ 9,959 (S.D. Tex. 1990) (holding that covenant against competition was supported by consideration in that it granted to the franchisee a franchise with all the connected benefits).

<sup>100</sup> *Sentilles v. Kwik-Kopy Corp.*, 652 So. 2d 79, 83 (La. Ct. App. 1995).

<sup>101</sup> *Id.*

<sup>102</sup> *Id.*

competition].”<sup>103</sup> The court noted that since “[no] reciprocal right to cancel was given...the franchisee...[had] only two choices: negotiate with [the franchisor] for a premature end to [the covenant] or breach the agreement.”<sup>104</sup> The court reasoned that because the franchise agreement as a whole “[conferred] a benefit on the plaintiff ... it is reasonable for the parties to agree to restrict [the] franchisee’s competition.”<sup>105</sup>

#### **4. Lack of Uniformity of Application**

Under common law, most courts do not permit a “lack of uniformity of application” defense against enforcement of covenants against competition in franchise agreements. Even favoritism within franchise systems is often tolerated so long as it does not “disrupt [a franchisee’s] relationship with its customers,” or otherwise cause significant harm.<sup>106</sup> A district court applying Ohio law upheld a covenant against competition against a former franchisee even though the franchisor had declined to enforce that same covenant against three other former franchisees.<sup>107</sup> The franchisor had professed a lack of interest in re-franchising the markets of those three others while asserting an interest in re-franchising the defendant-franchisee’s market.<sup>108</sup> The court found that “[any] selective enforcement of the clause here is grounded in credible business reasons and does not serve to render the noncompetition clause invalid.”<sup>109</sup>

While effective ‘lack of uniformity of application’ defenses are rare in the franchise context, in the employment context a former employee successfully defended against an employment agreement’s non-competition clause on precisely those grounds.<sup>110</sup> The defendant was the first and only employee the employer ever sued for violation of a post-term covenant against competition.<sup>111</sup> The court refused to enforce the covenant on equitable estoppel grounds, finding that “it would be inequitable to permit plaintiff to now rely on a non-compete agreement which it has so blithely ignored in the past.”<sup>112</sup> In another case, a district court applying Illinois law denied a preliminary injunction against a former franchisee operating in the same location citing, in part, the franchisor’s uneven application of covenants against competition.<sup>113</sup> The court stated that “the apparent history of [the franchisor] permitting

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<sup>103</sup> *Fogel v. Home X-Ray Serv. of Am., Inc.*, 1991 WL 834927 (Va. Cir. Ct. Apr. 19, 1991).

<sup>104</sup> *Id.*

<sup>105</sup> *Id.*

<sup>106</sup> *Adcom Express, Inc. v. EPK, Inc.*, C6-95-2128, 1996 WL 266412 (Minn. Ct. App. May 21, 1996).

<sup>107</sup> *Petland, Inc., v. Charles Gregory Hendrix*, Bus. Franchise Guide (CCH) ¶ 12,904 (S.D. Ohio 2009).

<sup>108</sup> *Id.*

<sup>109</sup> *Id.*

<sup>110</sup> *Surgidev Corp. v. Eye Tech., Inc.*, 648 F. Supp. 661 (D. Minn. 1986).

<sup>111</sup> *Id.*

<sup>112</sup> *Id.* at 698.

<sup>113</sup> *Baskin-Robbins Inc. v. Patel*, 264 F. Supp. 2d 607 (N.D. Ill. 2003).

others...to operate in [the franchisor's] former [franchise] locations...undermine[d] [the franchisor's] contention that they [needed] relief."<sup>114</sup>

Some states have passed franchise statutes pertaining to discriminatory treatment of franchisees by franchisors that may affect enforcement of covenants against competition. One Indiana statute broadly prohibits franchisors from "[discriminating] unfairly among its franchisees."<sup>115</sup> Other states' antidiscrimination franchise laws are more narrowly drafted; Washington's Franchise Investment Protection statute prohibits "[discrimination] between franchisees in the charges offered or made for royalties, goods, services, equipment, rentals, advertising services, or in any other business dealing."<sup>116</sup> It remains to be seen whether these statutes could be used effectively to defend against enforcement of covenants against competition in franchise agreements.

## 5. Exceeds Protection of Franchisor's Legitimate Interests

Franchisees may claim that a covenant against competition in a franchise agreement exceeds the protection of a franchisor's legitimate interests and thus must be reduced or rendered void. This can be a difficult defense as franchisors can usually name several legitimate, protectable interests that justify enforcement of a covenant against competition. A district court applying North Carolina law granted an injunction after finding that the franchisor had a legitimate interest "(i) in attracting a new franchisee to the market in which the terminated franchisee is operating; (ii) in preventing the customer confusion that inevitably occurs when a terminated franchisee continues serving the same products at the same location from which it previously operated its franchise; and (iii) in protecting its franchise system as a whole."<sup>117</sup> North Carolina courts also apply a "balance of hardships" test wherein "[if] a plaintiff cannot establish that irreparable harm is likely to occur in the absence of a preliminary injunction, that failure alone is sufficient to deny injunctive relief. Moreover, the required 'irreparable harm' must be 'neither remote nor speculative, but actual and imminent.'"<sup>118</sup>

Protection of the knowledge, experience, and customer contacts the franchisee accumulated during a franchise relationship can also serve as a legitimate interest. In enforcing a covenant against competition in a franchise agreement, one court found that the franchisee would be "unjustly enriched by using knowledge and experience gained from [the franchisor] to serve former and potential customers."<sup>119</sup> Deterrence of other franchisees' breaches has also been seen as a protectable interest. In a case before a district court applying Maryland law, a judge stated, "I have no doubt that the plaintiff would suffer irreparable harm if I were to deny the preliminary injunction...I think it is very realistic to expect that if a franchisee simply were to

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<sup>114</sup> *Id.* at 612.

<sup>115</sup> Ind. Code Ann. § 23-2-2.7-2.

<sup>116</sup> Wash. Rev. Code Ann. § 19.100.180.

<sup>117</sup> *Lockhart v. Home-Grown Indus. of Georgia, Inc.*, 2007 WL 2688551 (W.D.N.C. Sept. 10, 2007).

<sup>118</sup> *Meineke Car Care Centers, Inc. v. Quinones*, 2006 WL 1549708 (W.D.N.C. June 1, 2006).

<sup>119</sup> *Maaco Enterprises, Inc. v. Bremner*, 1998 WL 669936 (E.D. Pa. Sept. 29, 1998); see also *Intermountain Eye & Laser Centers, P.L.L.C. v. Miller*, 127 P.3d 121, 127 (Idaho 2005) (finding that "non-compete provisions must be reasonable, which is to say they must not be more restrictive than necessary to protect a legitimate business interest, must not be unduly harsh and oppressive to the employee, and must not be injurious to the public").

stop paying fees or stop other things that were due...that would be a clear signal that other franchisees could do the same.”<sup>120</sup>

Where a franchisor has no other existing franchisees, at least one court has found a covenant against competition to be unenforceable in those circumstances, since it would not serve to protect any legitimate business interest of the franchisor.<sup>121</sup>

Franchisees may defend against covenants against competition by demonstrating a lack of competition with their former franchisor. In Alabama, a franchisor was denied an injunction against a former franchisee after finding that the franchisor was “not currently operating a franchise in the...area and, additionally, the closest [franchise being operated by the franchisor was] located...approximately one hundred and fifty (150) miles away from [the franchisee’s business].”<sup>122</sup>

## **G. Judicial Remedies for Breaches of Covenants Against Competition**

### **1. Damages**

Many courts are unwilling to award damages to franchisors seeking relief from a franchisee’s violation of a covenant against competition in a franchise agreement. In one case, a district court applying Pennsylvania law granted a franchisor an injunction while denying damages.<sup>123</sup> The court recognized that “[although] some of the damages involved...may be measurable in monetary terms, others -- such as damage to goodwill -- [were] too nebulous to ascertain.”<sup>124</sup> In judging a similar case, a district court applying Utah law also enforced a covenant against competition in a franchise agreement by injunction while denying damages despite an explicit ‘damages clause’ in the franchise agreement.<sup>125</sup> The court reasoned that “[the franchisor’s] intangible assets, such as goodwill and the strength of its franchise [are] difficult to measure in money ... [the] court does not agree that the damages clause in the Franchise Agreement would be a reliable guide to attempt to do so.”<sup>126</sup>

Most courts examine whether damages are even capable of remedying the harm caused by a franchisee’s violation of a covenant against competition; when they are not, courts typically

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<sup>120</sup> *ATL International, Inc. v. Baradar*, Bus. Franchise Guide (CCH) ¶ 11,345 (D. Md. 1997).

<sup>121</sup> *Marking Associates, Inc. v. Charles C. Carter and Sports, Inc.*, Bus. Franchise Guide (CCH) ¶ 9,857 (D. Kan. 1991) (finding that any restrictions in space and time cannot be reasonably necessary where no legitimate interest would be protected).

<sup>122</sup> *Pirtek, USA LLC v. Whitehead*, 2006 WL 2038651 (S.D. Ala. Apr. 27, 2006).

<sup>123</sup> *Novus Franchising, Inc. v. Taylor*, 795 F. Supp. 122 (M.D. Pa. 1992).

<sup>124</sup> *Id.* at 133.

<sup>125</sup> *Bad Ass Coffee Co. of Hawaii, Inc. v. JH Nterprises, L.L.C.*, 636 F. Supp. 2d 1237 (D. Utah 2009).

<sup>126</sup> *Id.* at 1250; see also *Certified Restoration Dry Cleaning Network, L.L.C. v. Tenke Corp.*, 511 F. 3d 535, 550 (6th Cir. 2007) (“The likely interference with customer relationships resulting from the breach of a non-compete agreement is the kind of injury for which monetary damages are difficult to calculate.”); *R.J. Gators Franchise Systems, Inc. v. MBC Restaurants, Inc.*, Bus. Franchise Guide (CCH) ¶ 13,204 (M.D. Fla. 2005) (finding that “monetary damages are typically quite difficult to establish [for breaches of covenants against competition in franchise agreements] and often cannot adequately compensate for that type of breach”).



deny damages. In applying Georgia law, a district court refused to award damages, stating “it is difficult to ascertain the monetary value of [goodwill] injuries...it may not be possible to undo some of the injuries through monetary damages.”<sup>127</sup> In another case, a district court applying Maryland law enforced a covenant against competition in a franchise agreement after finding that the franchisee “blatantly ignored the non-compete provisions of its agreement with [the franchisor] in directly competing with the plaintiff and utilizing [the franchisor’s] proprietary information,” thus resulting in significant harm to the franchisor.<sup>128</sup> However, the court also found that “[the] speculative availability of [monetary] damages...for [the franchisee’s] violations is little more than a hope (and a thin one, indeed).”<sup>129</sup>

## 2. Injunctive Relief

Injunctions are the most common form of relief courts issued against former franchisees in violation of covenants against competition in franchise agreements.<sup>130</sup> In enforcing a covenant against a former franchisee, the Iowa Supreme Court noted that injunctions are “the most usual method of [enforcing] noncompetition agreements ... [they] protect the interests of the immediate parties [and] other franchisees against competitive activities.”<sup>131</sup> Thus, injunctions will typically be granted so long as the covenant is otherwise enforceable.<sup>132</sup> Where a preliminary injunction is issued against a former franchisee, the franchisor may be compelled to compensate the franchisee for damages “in the event they are found to have been wrongfully enjoined or restrained.”<sup>133</sup>

For many courts, a demonstration of irreparable harm in the absence of an injunction is required before the franchisor may be granted injunctive relief. The tests and/or definitions for irreparable harm have some slight variation among the states; for example, Illinois courts require the franchisor to “show that an award of damages at the end of trial will be seriously deficient as a remedy for the harm suffered.”<sup>134</sup> Ohio courts require “a showing that money

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<sup>127</sup> *SmallBizPros, Inc. v. Court*, 414 F. Supp. 2d 1245, 1251 (M.D. Ga. 2006).

<sup>128</sup> *NaturaLawn of Am., Inc. v. West Group, LLC*, 484 F. Supp. 2d 392, 401 (D. Md. 2007).

<sup>129</sup> *Id.* at 402; *see also Prosperity Sys., Inc. v. Ali*, 2010 WL 5174939 (D. Md. Dec. 15, 2010) (finding that violation of a non-compete clause resulted in irreparable injury to a franchisor’s good will and reputation for which there could be no meaningful monetary recovery); *Pepsi-Cola Bottling Company of Pittsburg, Inc. v. Pepsico, Inc.*, Bus. Franchise Guide (CCH) ¶ 12,248 (D. Kan. 2001) (holding that though the classic remedy for breach of contract is damages, irreparable injury caused by breach of a covenant against competition in a franchise agreement would be more appropriately addressed through injunctive relief).

<sup>130</sup> *Carvel Corp. v. DePaola*, 2001 WL 528203 (Conn. Super. Ct. Apr. 24, 2001) (holding that a “[franchisor’s] operation of identical competing stores in the former [franchise] locations...will continue to cause [the franchisor] to suffer a loss of proprietary information, customer confusion, loss of goodwill, loss of profit...and a diminution of the integrity of the [franchisor’s] system”).

<sup>131</sup> *Casey’s Gen. Stores, Inc. v. Campbell Oil Co., Inc.*, 441 N.W. 2d 758, 761 (Iowa 1989).

<sup>132</sup> *Meineke Car Care Centers, Inc. v. Bica*, 2011 WL 4829420 (W.D.N.C. Oct. 12, 2011) (a covenant not to compete is valid in North Carolina if: 1) it is reasonably necessary to protect the legitimate interests of the person seeking enforcement; 2) it is reasonable with respect to time and territory; and 3) it does not interfere with the interest of the public); *Tutor Time Learning Centers, LLC v. Larzak, Inc.*, 2007 WL 2025214 (N.D. Ind. July 6, 2007) (“injunctive relief is available when...remedies at law, such as monetary damages, are inadequate to compensate for that injury”).

<sup>133</sup> *Novus Franchising, Inc. v. Oksendahl*, 07-1964 JRTFLN, 2007 WL 2084143 (D. Minn. July 17, 2007).

<sup>134</sup> *P.P. & K., Inc. v. McCumber*, Bus. Franchise Guide (CCH) ¶ 10,434 (N.D. Ill. 1994).

damages...will not adequately compensate,” and define ‘irreparable harm’ as “[harm that is] substantial to a material degree.”<sup>135</sup>

### 3. Other

Where an injunction defined by geographic boundaries or temporal restrictions will not protect the legitimate interests of a franchisor, some courts will grant alternative forms of relief. In enforcing a covenant against competition in a franchise agreement, a district court applying New York law imposed a non-solicitation requirement on a franchisee.<sup>136</sup> The franchisee in that case was “enjoined from soliciting [via] a telephone call or a personal meeting ... any individual appearing in [franchisor’s] files.”<sup>137</sup>

## III. LEGISLATIVE LANDSCAPE

The enforceability of non-compete provisions in the franchise context remains primarily rooted in the state law controlling the agreement at issue. A number of states maintain statutes that deal either directly, or indirectly, with the enforcement of non-compete provisions.

### A. Franchise Specific State Laws that Address Covenants Against Competition in Franchise Agreements

#### 1. Illinois

Illinois addresses non-compete agreements in the Illinois Franchise Disclosure Act with regard to non-renewal of franchise agreements.<sup>138</sup> The Act states that it is a violation thereof for a franchisor to refuse to renew a franchise located in Illinois “without compensating the franchisee either by repurchase or by other means for the diminution in the value of the franchised business caused by the expiration of the franchise ... where the franchisee is barred by the franchise agreement ... from continuing to conduct substantially the same business under another trademark, service mark, trade name or commercial symbol in the same area subsequent to the expiration of the franchise; or the franchisee has not been sent notice of the franchisor's intent not to renew the franchise at least 6 months prior to the expiration date of the franchise.”<sup>139</sup> The plain intent of the statute is to ensure compensation to a former franchisee when they will not be able to engage in a competing business and have not been given time to sell the business.

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<sup>135</sup> *Physicians Weight Loss Centers of America, Inc. v. Ligon*, Bus. Franchise Guide (CCH) ¶ 9,782 (N.D. Ohio 1991); see also *Jiffy Lube Int'l, Inc. v. Weiss Bros., Inc.*, 834 F. Supp. at 692 (“[a franchisor] must also demonstrate that the failure to grant a preliminary injunction will result in irreparable injury”); *Certified Restoration Dry Cleaning Network, L.L.C. v. Tenke Corp.*, 511 F.3d at 550 (finding that “[the] loss of customer goodwill often amounts to irreparable injury because the damages flowing from such losses are difficult to compute”).

<sup>136</sup> *Winston Franchise Corp. v. Williams*, 1992 WL 7843 (S.D.N.Y. Jan. 10, 1992).

<sup>137</sup> *Id.*

<sup>138</sup> Illinois Franchise Disclosure Act of 1987, 815 Ill. Comp. Stat. Ann. 705/20.

<sup>139</sup> *Id.*

## 2. Indiana

The Indiana Deceptive Franchise Practices Act allows for post-termination covenants not to compete so long as they comply with certain requirements as to time and geographic restraints.<sup>140</sup> Indiana makes it unlawful for any franchise agreement between a franchisor and a franchisee who is a resident of Indiana or a non-resident who operates in Indiana to contain a provision requiring a franchisee to covenant not to compete with the franchisor for a period longer than three years or in an area greater than the exclusive area granted by the franchise agreement or, in absence of such a provision in the agreement, an area of reasonable size, upon termination of or failure to renew the franchise.<sup>141</sup> Thus, in construing covenants not to compete under Indiana law, the legislature has concluded that a covenant not to compete of three years or less is reasonable, and the courts are left to determine if a geographic restriction is reasonable where there is no exclusive area.<sup>142</sup>

## 3. Iowa

Iowa has two different franchise statutes that apply to covenants not to compete depending on whether the franchise agreement was entered on or after July 1, 2000 or before that date.<sup>143</sup> For franchise agreements entered prior to that date, the statute prohibits post-termination enforcement of covenants not to compete after termination or refusal to renew unless “it is one which relies on a substantially similar marketing program” of the franchise or unless the “franchisor offers in writing no later than ten business days before expiration of the franchise to purchase the assets of the franchised business for its fair market value as a going concern.”<sup>144</sup> The pre-July 1, 2010 statute also prohibited enforcement of a covenant not to compete against the transferor after a transfer of the franchise agreement “from engaging in a lawful occupation or enterprise.”<sup>145</sup> However, after transfer of the franchise agreement, the franchisor may prohibit the transferor from “exploit[ing] the franchisor’s trade secrets or intellectual property.”<sup>146</sup> Additionally, the statute applying to the pre-July 1, 2010 franchise agreements prohibits a franchisor from refusing to renew a franchise agreement unless both proper notice is given of the intent not to renew and one of certain circumstances exists, provided that, upon expiration, the franchisor agrees not to enforce any covenant not to compete against the franchisee.<sup>147</sup>

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<sup>140</sup> Ind. Code Ann. § 23-2-2.7-1.

<sup>141</sup> *Id.*

<sup>142</sup> See *Hacienda Mexican Restaurant of Kalamazoo Corp. v. Hacienda Franchise Group*, 569 N.E. 2d 661, 668 (Ind. Ct. App. 1991) (declining to address reasonableness of geographic scope of post-term covenant not to compete where no record evidence existed to support that a legal right under the contract would be violated by franchisees “operating a Mexican restaurant in general.”).

<sup>143</sup> See Iowa Code § 523H.2.A (“[T]his chapter does not apply to a franchise agreement which is entered into on or after July 1, 2000. A franchise agreement entered on or after July 1, 2000, shall be subject to section 537A.10.”).

<sup>144</sup> See Iowa Code § 523H.8.

<sup>145</sup> See Iowa Code § 523H.5.

<sup>146</sup> *Id.*

<sup>147</sup> See Iowa Code § 523H.5.

The current statute, however, shows a change in the public policy of the state of Iowa with regard to covenants not to compete in franchise agreements. It, like its predecessor, prohibits covenants not to compete when a franchisor refuses to renew, because it is withdrawing from the market served by the franchisee and has provided proper notice.<sup>148</sup> The current Act does not, however, apply to post-term covenants not to compete generally or upon transfer as did the prior Act, and therefore, shows an intent to allow greater enforcement of covenants not to compete.

#### 4. Louisiana

Under Louisiana law, agreements which restrain anyone from exercising a lawful profession, trade, or business of any kind, unless specifically excepted, are null and void.<sup>149</sup> However, this provision does not apply to a franchisor and a franchisee.<sup>150</sup> Rather, parties to a franchise agreement are entitled to agree that during the term of the franchise agreement the franchisee may not compete with the franchisor or other franchisees.<sup>151</sup> Additionally, parties to a franchise agreement may agree that for a period of two years after severance of the relationship the franchisee may not compete with the franchisor or other franchisees of the franchisor.<sup>152</sup> The statute does not, however, set forth a geographic limitation on covenants not to compete.<sup>153</sup>

#### 5. Michigan

Michigan addresses non-compete agreements in the Michigan Franchise Investment Law with regard to non-renewal of franchise agreements.<sup>154</sup> The Act states that a provision in a franchise agreement is “void and unenforceable” if it permits a franchisor to refuse to renew a franchise agreement without fairly compensating the franchisee by repurchase for the fair market value if “the franchisee’s inventory, supplies, equipment, fixtures and furnishings,” but only if the term of the franchise agreement is less than five years and the franchisee is prohibited from conducting “substantially the same business” “in the same area” or the franchisee did not receive proper and timely notice of franchisor’s intent not to renew.<sup>155</sup> An in-term covenant is, however, valid, and violation of the provision may be the basis for termination of the franchise agreement.<sup>156</sup>

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<sup>148</sup> See Iowa Code § 537A.10.

<sup>149</sup> See La. Rev. Stat. Ann. § 23:921A(1).

<sup>150</sup> See *Sentilles v. Kwik-Copy Corp.*, 652 So. 2d 79 (La. App. Ct. 1995) (franchise relationship is not an employer/employee relationship making Louisiana’s public policy against non-compete agreements inapplicable).

<sup>151</sup> See La. Rev. Stat. Ann. § 23:921F(1).

<sup>152</sup> See La. Rev. Stat. Ann. § 23:921F(2).

<sup>153</sup> *Id.*

<sup>154</sup> Mich. Comp. Laws § 445.1527.

<sup>155</sup> Mich. Comp. Laws § 445.1527(d).

<sup>156</sup> See 1979-1980 Mich. Op. Att’y Gen. 531 (1980).

## 6. Minnesota

Minnesota law requires that a franchisor must state the conditions of any covenant not to compete in its disclosure document.<sup>157</sup> Additionally, under Minnesota law it is an unfair and an inequitable practice<sup>158</sup> to “enforce any unreasonable covenant not to compete after the franchise relationship ceases to exist.”<sup>159</sup>

### B. General Statutes on Covenants Against Competition That May be Applicable to Covenants in Franchise Agreements

#### 1. Alabama

While Alabama does not have a statute that specifically addresses the legality of covenants against competition in the context of franchise agreements, there is a statute that governs restraining contracts in general. Ala. Code § 8-1-1 (1975) states:

(a) Every contract by which anyone is restrained from exercising a lawful profession, trade, or business of any kind otherwise than is provided by this section is to that extent void.

(b) One who sells the good will of a business may agree with the buyer and one who is employed as an agent, servant or employee may agree with his employer to refrain from carrying on or engaging in a similar business and from soliciting old customers of such employer within a specified county, city, or part thereof so long as the buyer, or any person deriving title to the good will from him, or employer carries on a like business therein.

(c) Upon or in anticipation of a dissolution of the partnership, partners may agree that none of them will carry on a similar business within the same county, city or town, or within a specified part thereof, where the partnership business has been transacted.

On its face, this would appear to render void covenants against competition in Alabama. However, since 1984, Alabama courts have determined that such covenants are enforceable under Alabama’s judicially created partial restraint of trade exception so long as they are “properly restricted as to territory, time and persons [and] where they are supported by sufficient consideration.”<sup>160</sup> In *Gafnea v. Pasquale Food Co., Inc.*, the Supreme Court of Alabama determined that a covenant barring operation of a similar business within 5 miles of a franchisee’s former franchise for eighteen months satisfied the requirements of a partial restraint of trade exception.<sup>161</sup> This remains the only standard for determining to what extent covenants against competition in franchise agreements may qualify for exemption from Ala. Code § 8-1-1.

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<sup>157</sup> Minn. R. 2860.3500(8)(N).

<sup>158</sup> Minn. Stat. §§ 80C.01-.30 (specifically § 80C.14).

<sup>159</sup> Minn. R. 2860.4400(I).

<sup>160</sup> *Gafnea v. Pasquale Food Co., Inc.*, 454 So. 2d 1366, 1368 (Ala. 1984).

<sup>161</sup> *Id.*

## 2. Arizona

The Arizona Vehicle Dealer Requirements and Restrictions Act<sup>162</sup> could potentially be applied to certain covenants against competition in franchise agreements, specifically new car dealerships. It states:

A manufacturer, factory branch, distributor, distributor branch or field representative or an officer, agent or representative of a manufacturer, factory branch, distributor, distributor branch or field representative shall not require, coerce or attempt to coerce any new motor vehicle dealer in this state to refrain from participation in the management of, investment in or acquisition of any other line-make of new motor vehicle or related products unless justified by reasonable business considerations.<sup>163</sup>

There are no cases construing this statute; it remains to be seen what impact this may have on Arizona's treatment of covenants against competition in franchise agreements.

## 3. California

California does not have a statute specifically addressing covenants against competition in the franchise context, but the California Business and Professional Code renders void covenants against competition generally. Section 16600 states "[except] as provided in this chapter, every contract by which anyone is restrained from engaging in a lawful profession, trade or business of any kind is to that extent void."<sup>164</sup> The chapter lays out exceptions to 16600 for the sale of goodwill in a business,<sup>165</sup> dissolution of a partnership<sup>166</sup> and dissolution or sale of a limited liability company.<sup>167</sup>

The exceptions to 16600 are narrowly construed and do not generally cover covenants against competition in franchise agreements unless there is appreciable exchange of goodwill involved in the transaction. *In Scott v. Snelling & Snelling, Inc.*,<sup>168</sup> a district court applying California law refused to enforce a covenant restraining competition against a former franchisee. The court found that franchise agreements alone did not "constitute sales of goodwill in a business under California law as set forth in section 16601," and therefore struck the clause.<sup>169</sup>

Recently, the courts have adopted an even more stringent interpretation of 16600. For decades, California courts recognized a narrow restraint exception that allowed a covenant to be enforced "where one is barred from pursuing only a small or limited part of a business, trade

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<sup>162</sup> Ariz. Rev. Stat. Ann. § 28-4458.

<sup>163</sup> *Id.* at 4458B.

<sup>164</sup> Cal. Bus. & Prof. Code § 16600.

<sup>165</sup> *Id.* at § 16601.

<sup>166</sup> *Id.* at § 16602.

<sup>167</sup> *Id.* at § 16602.5.

<sup>168</sup> *Scott v. Snelling & Snelling, Inc.*, 732 F. Supp. 1034 (N.D. Cal. 1990).

<sup>169</sup> *Id.* at 1041.

or profession.”<sup>170</sup> However, in 2008 the court rejected this long-running common law exception stating, “[noncompetition] agreements are invalid under section 16600 in California, even if narrowly drawn, unless they fall within the applicable statutory exceptions of sections 16601, 16602, or 16602.5.”<sup>171</sup> The only surviving judicially created exception to 16600 is for the protection of trade secrets, though this typically only prohibits conduct “that would have been subject to judicial restraint under the law of unfair competition, absent the contract.”<sup>172</sup>

#### 4. Colorado

Colorado has a statute governing non-compete agreements in employment contracts that has been applied to franchise agreements.<sup>173</sup> The statute states: (1) any covenant not to compete which restricts the right of any person to receive compensation for performance of skilled or unskilled labor for any employer shall be void, but this subsection (2) shall not apply to:

- (a) Any contract for the purchase and sale of a business or the assets of a business;
- (b) Any contract for the protection of trade secrets;
- (c) Any contractual provision providing for recovery of the expense of educating and training an employee who has served an employer for a period of less than two years;
- (d) Executive and management personnel and officers and employees who constitute professional staff to executive and management personnel.

The exceptions in section 8-2-113 that are most applicable in the franchise context are those for sale of a business and protection of trade secrets.

The Colorado Court of Appeals<sup>174</sup> addressed the applicability to franchise agreements of the trade secrets exception in *Gold Messenger, Inc. v. McGuay*.<sup>175</sup> There, the court enforced a covenant against a former franchisee on the grounds that the franchisee was using the franchisor’s proprietary advertising methods. The court also looked to the Colorado Uniform Trade Secrets Act, which states “[temporary] and final injunctions including affirmative acts may be granted on such equitable terms as the court deems reasonable to prevent or restrain actual or threatened misappropriation of a trade secret.”<sup>176</sup>

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<sup>170</sup> *Boughton v. Socony Mobil Oil Co.*, 231 Cal. App. 2d 188, 192 (1964).

<sup>171</sup> *Edwards v. Arthur Andersen LLP*, 189 P. 3d 285, 297 (Cal. 2008).

<sup>172</sup> *Metro Traffic Control, Inc. v. Shadow Traffic Network*, 22 Cal. App. 4th 853, 861 (1994).

<sup>173</sup> Colo. Rev. Stat. § 8-2-113.

<sup>174</sup> This issue has yet to be decided by the Colorado Supreme Court.

<sup>175</sup> *Gold Messenger, Inc. v. McGuay*, 937 P.2d 907 (Colo. Ct. App. 1997).

<sup>176</sup> Colo. Rev. Stat. § 7-74-103.

The Colorado court has also clarified the sale of business exception as applied in the franchise context. In *Keller Corp. v. Kelley*,<sup>177</sup> the court upheld a covenant not to compete solely on section 8-2-113(2)(a) grounds in the franchise context, reasoning that “once the franchised term ends, the franchisor may well possess an interest worthy of protection ... [a] covenant not to compete protects the goodwill of [a] business.”<sup>178</sup> Thus, Colorado courts have expressed a willingness to uphold covenants against competition in franchise agreements so long as they are reasonable in terms of length and scope.

## 5. Florida

Florida has three sets of rules applicable to covenants against competition in franchise agreements:

- a) Rules governing contracts effective prior to June 28, 1990;
- b) Rules governing contracts effective on or after June 28, 1990, but before July 1, 1996; and
- c) Rules governing contracts effective on or after July 1, 1996.

Which set of rules applies depends upon the date of the franchise agreement. The rules governing contracts effective in each period are quite different; according to the Florida Bar Journal, “practitioners will continue to find ‘traps for the unwary’ so long as contracts effective before July 1, 1996, continue in force.”<sup>179</sup>

Before June 3, 1990, franchise agreements were enforced subject to Section 542.12 of the Florida Statutes, the first Florida statute to explicitly authorize contractual restrictions upon competition. However, Florida courts began to apply judicially created standards that ignored the statute. This approach to enforcement “provided no principled way for the courts to decline to enforce contractual restrictions upon competition that were not justified by the need to protect any substantial ‘legitimate business interest’ and lent itself to distortion by result-oriented courts.”<sup>180</sup> The Supreme Court of Florida eventually limited Florida courts’ discretion to “[determining] the reasonableness of time and geographic area limitations”<sup>181</sup> Now when determining the enforceability of covenants against competition in franchise agreements made before June 30, 1990, Florida courts look to revised code to Section 542.33, which allows for enforcement when the party in breach “continues to carry on a like business,” and the covenant is “reasonably limited in time and area.”<sup>182</sup>

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<sup>177</sup> *Keller Corp. v. Kelley*, 187 P. 3d 1133 (Colo. Ct. App. 2008).

<sup>178</sup> *Id.* at 1138.

<sup>179</sup> John A. Grant, Jr. & Thomas T. Steele, *Restrictive Covenants: Florida Returns to the Original “Unfair Competition” Approach for the 21st Century*, Fla. B.J., November 1996, at 53, 55.

<sup>180</sup> *Id.*

<sup>181</sup> *Gupton v. Vill. Key & Saw Shop, Inc.*, 656 So. 2d 475, 477 (Fla. 1995).

<sup>182</sup> Fla. Stat. § 542.33.



Franchise agreements entered into between June 1990 and July 1996 are enforced subject to the legislative amendments to section 542.33, which were intended to reduce the use of the ‘contract-oriented’ approach.<sup>183</sup> Courts evaluating covenants written during this period must take into account “a standardless ‘unreasonableness’ defense...[and] a standardless ‘contrary to the public health, safety or welfare’ defense”.<sup>184</sup>

The modern (post July 1, 1996) version of Florida’s statute regulating contracts in restraint of trade defines its terms much more clearly than previous iterations and is also more comprehensive. It states “enforcement of contracts that restrict or prohibit competition during or after the term of restrictive covenants, so long as such contracts are reasonable in time, area, and line of business, is not prohibited,” followed by an exhaustive litany of definitions for terms, burden of proof requirements, etc.<sup>185</sup> An unreasonable restriction does not necessarily render a covenant against competition entirely void; if a covenant is “modified to be reasonable, enforcement of the modified covenant would not violate the statute.”<sup>186</sup>

## 6. Georgia

Georgia’s constitution was amended in 2010 to allow for covenants against competition in franchise agreements.<sup>187</sup> The Georgia constitution now states:

(2) The General Assembly shall have the power to authorize and provide by general law for judicial enforcement of contracts or agreements restricting or regulating competitive activities between or among:

- (A) Employers and employees;
- (B) Distributors and manufacturers;
- (C) Lessors and lessees;
- (D) Partnerships and partners;
- (E) Franchisors and franchisees;
- (F) Sellers and purchasers of a business or commercial enterprise; or
- (G) Two or more employers.

(3) The authority granted to the General Assembly in subparagraph (c)(2) of this paragraph shall include the authority to grant to courts by general law the power to limit the duration, geographic area, and scope of prohibited activities provided in a contract or agreement restricting or regulating competitive activities to render such contract or agreement reasonable under the circumstances for which it was made.<sup>188</sup>

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<sup>183</sup> *Id.*

<sup>184</sup> *Id.*; see also *Hapney v. Cent. Garage, Inc.*, 579 So. 2d 127, 130 (Fla. Dist. Ct. App. 1991) (finding that under the amended statute, the court must readopt the legitimate business interest standard).

<sup>185</sup> Fla. Stat. § 542.335.

<sup>186</sup> *Health Care Fin. Enterprises, Inc. v. Levy*, 715 So. 2d 341, 342 (Fla. Dist. Ct. App. 1998).

<sup>187</sup> *Cox v. Altus Healthcare & Hospice, Inc.*, 706 S.E.2d 660, 663 (Ga. Ct. App. 2011).

<sup>188</sup> Ga. Const. Art. III, § 6, ¶ V.

Prior to this amendment, Georgia courts disfavored covenants against competition in franchise agreements.<sup>189</sup> The Georgia Court of Appeals would only enforce a covenant against competition in the franchise context if “it [was] strictly limited in time and territorial effect and is otherwise reasonable.”<sup>190</sup> While Georgia’s constitution now allows for a more liberal enforcement of covenants against competition in franchise agreements, covenants entered into prior to ratification are still evaluated under the previous standard.<sup>191</sup>

## 7. Michigan

In addition to the Michigan Franchise Investment Law discussed above, Michigan courts also have applied the Michigan Antitrust Reform Act (“MARA”) in the franchise context. MARA’s section on non-compete clauses states:

(1) An employer may obtain from an employee an agreement or covenant which protects an employer's reasonable competitive business interests and expressly prohibits an employee from engaging in employment or a line of business after termination of employment if the agreement or covenant is reasonable as to its duration, geographical area, and the type of employment or line of business. To the extent any such agreement or covenant is found to be unreasonable in any respect, a court may limit the agreement to render it reasonable in light of the circumstances in which it was made and specifically enforce the agreement as limited.

(2) This section shall apply to covenants and agreements which are entered into after March 29, 1985.<sup>192</sup>

Michigan courts apply section 445.774a of MARA in the franchise context by analogizing the franchise relationship to the employer-employee relationship. In one case involving enforcement of a covenant in a franchise agreement, the Michigan Court of Appeals said it was “convinced that had the Legislature intended its enactment of section 4a to generally prohibit all noncompetition agreements other than those between employers and employees ... the Legislature would have done so expressly.”<sup>193</sup> The court was explaining that, even though MARA only specifically mentions employer-employee contracts, it can be applied to other contracts so long as the terms of any restrictions are reasonable.<sup>194</sup>

Prior to MARA, Michigan courts looked to MCLA § 445.761 when dealing with covenants against competition in the franchise context:

All agreements and contracts in which any person, co-partnership, or corporation promises or agrees not to engage in any avocation, employment, pursuit, trade,

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<sup>189</sup> *Allen v. Hub Cap Heaven, Inc.*, 484 S.E.2d 259 (Ga. Ct. App. 1997).

<sup>190</sup> *Id.* at 264.

<sup>191</sup> *Hix v. Aon Risk Services South, Inc.*, 2011 WL 5870059 (N.D. Ga. Nov. 22, 2011).

<sup>192</sup> Mich. Comp. Laws § 445.774(a) (emphasis added).

<sup>193</sup> *Bristol Window & Door, Inc. v. Hoogenstyn*, 650 N.W.2d 670, 680 (Mich. Ct. App. 2002).

<sup>194</sup> *Id.*; see also *Certified Restoration Dry Cleaning Network, L.L.C. v. Tenke Corp.*, 511 F.3d 535, 546 (6th Cir. 2007) (finding by Sixth Circuit that MARA § 445.774(a) applies to franchise agreements).

profession, or business, whether reasonable or unreasonable, partial or general, limited or unlimited are hereby declared to be against public policy and are illegal and void....This act shall not apply to any contract mentioned in this act, nor in restraint of trade where the only object is to protect the vendee or transferee of a trade, pursuit, avocation, profession or business, or the goodwill thereof, sold and transferred for a valuable consideration in good faith, and without any intent to create, build up, establish or maintain a monopoly; nor to any contract of employment under which the employer furnishes or discloses to the employee a list of customers or patrons, commonly called a route list.<sup>195</sup>

The Court of Appeals of Michigan has since declared that “a covenant unenforceable under the former statute did not become enforceable upon its repeal.”<sup>196</sup> Thus, while MARA allows for covenants against competition in franchise agreements, section 445.761 still applies to those that were entered into prior to its repeal in 1985.

## **8. Montana**

Montana does not have a statute specifically addressing covenants against competition in the franchise context. Instead, Montana courts rely on a general statute governing covenants against competition that states “[any] contract by which anyone is restrained from exercising a lawful profession, trade, or business of any kind, otherwise than is provided for by 28-2-704 or 28-2-705, is to that extent void.”<sup>197</sup> Section 28-2-704 creates an exception for the sale of goodwill of a business while outlining general limits of scope. Section 28-2-705 provides an exception for the dissolution of a partnership.

The Montana statute was first applied to a franchise agreement in *H & R Block Tax Services LLC v. Kutzman*.<sup>198</sup> There, a district court applying Montana law upheld the franchise agreement’s covenant against competition because it fit within the limits of section 28-2-704 and because it was “not so onerous as to interfere with the interests of the public.”<sup>199</sup>

## **9. North Dakota**

North Dakota has a statute of general application that could apply in the franchise context: “Every contract by which anyone is restrained from exercising a lawful profession, trade, or business of any kind is to that extent void, except:

1. One who sells the goodwill of a business may agree with the buyer to refrain from carrying on a similar business within a specified county, city, or a part of either, so long as the buyer or any person deriving title to the goodwill from the buyer carries on a like business therein.

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<sup>195</sup> Mich. Comp. Laws § 445.761.

<sup>196</sup> *Prod. Finishing Corp. v. Shields*, 405 N.W. 2d 171, 176 (Mich. Ct. App. 1987).

<sup>197</sup> Mont. Code Ann. § 28-2-703.

<sup>198</sup> *H & R Block Tax Services LLC v. Kutzman*, 681 F. Supp. 2d 1248 (D. Mont. 2010).

<sup>199</sup> *Id.* at 1252.

2. Partners, upon or in anticipation of a dissolution of the partnership, may agree that all or any number of them will not carry on a similar business within the same city where the partnership business has been transacted, or within a specified part thereof.<sup>200</sup>

Section 9-08-06 has not been applied in the franchise context, but has been used in employment cases. In *Earthworks, Inc. v. Sehn*, the court struck a non-compete clause explaining that the “statute’s purpose is to promote commercial activity by restricting the ability of individuals to form agreements not to compete.”<sup>201</sup> The court noted that the exceptions listed in the statute are narrow and apply only to partnerships and to the sale of a business but “only if it is connected with the sale of the goodwill of a business [as well].”<sup>202</sup>

## 10. Oklahoma

Oklahoma has two statutes that could be applied in the franchise context. One of them is an anti-trust statute that states “[every] act, agreement, contract, or combination in the form of a trust, or otherwise, or conspiracy in restraint of trade or commerce within [Oklahoma] is hereby declared to be against public policy and illegal.”<sup>203</sup> Oklahoma courts have interpreted this statute to mean that only unreasonable restraints of trade are prohibited. In *Crown Paint Co. v. Bankston*,<sup>204</sup> the Supreme Court of Oklahoma found that only “unreasonable restraints of trade, as measured by the ‘rule of reason’” constitute a violation.<sup>205</sup>

Another statute that could be applied in the franchise context deals with unlawful contracts generally:

Every contract by which anyone is restrained from exercising a lawful profession, trade or business of any kind, otherwise than as provided by Sections 218 and 219 of this title, or otherwise than as provided by Section 2 of this act, is to that extent void.<sup>206</sup>

Sections 218 and 219 provide exceptions for the sale of goodwill of a business and dissolution of a partnership respectively.<sup>207</sup> While Oklahoma courts have not applied either of these exceptions in the franchise context, one district court applying Oklahoma law determined that a “covenant [against competition in a franchise agreement] would be valid under 15 O.S. § 217 [because of the exception provided by section 218 for goodwill].”<sup>208</sup>

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<sup>200</sup> N.D. Cent. Code § 9-08-06.

<sup>201</sup> *Earthworks, Inc. v. Sehn*, 553 N.W.2d 490, 492 (N.D. 1996).

<sup>202</sup> *Id.*

<sup>203</sup> Okla. Stat. Ann. tit. 79, § 203.

<sup>204</sup> *Crown Paint Co. v. Bankston*, 640 P.2d 948 (Okla. 1981).

<sup>205</sup> *Id.* at 950.

<sup>206</sup> Okla. Stat. Ann. tit. 15, § 217.

<sup>207</sup> Okla. Stat. Ann. tit. 15, § 218-219.

<sup>208</sup> *Domino’s Pizza, Inc. v. El-Tan, Inc.*, 1995 WL 367893 (N.D. Okla. Apr. 28, 1995).

In the employment context, Oklahoma courts have recently interpreted section 217 to mean that “non-compete provisions...are void as a matter of law pursuant to 15 O.S.2001 § 217,” though this has yet to be applied to franchise agreements.<sup>209</sup>

#### **11. Oregon**

Oregon also has two statutes that may be applicable to covenants against competition in franchise agreements. One, an employment statute regulating non-compete clauses<sup>210</sup> and another statute regulating competition involving trade secrets.<sup>211</sup> Neither of these statutes has yet been applied in the franchise context.

#### **12. South Carolina**

The South Carolina Trade Secrets Act provides that “a contractual duty not to disclose or divulge a trade secret, to maintain the secrecy of a trade secret, or to limit the use of a trade secret must not be considered void or unenforceable or against public policy for lack of a durational or geographical limitation.”<sup>212</sup> The extent to which this statute could be used to limit former franchisees from competition has yet to be seen.

#### **13. South Dakota**

South Dakota has a statute covering covenants against competition generally which states “[A]ny contract restraining exercise of a lawful profession, trade, or business is void to that extent, except as provided by §§ 53-9-9 to 53-9-12, inclusive.”<sup>213</sup> The exceptions mentioned in section 53-9-8 are for protection of the sale of the goodwill of a business and for insurance company employees.<sup>214</sup> As per the Supreme Court of South Dakota, these exceptions are “construed narrowly so as to promote [South Dakota’s] prohibition against contracts in restraint of trade.”<sup>215</sup>

#### **14. Texas**

Texas courts look to the Texas Business and Commerce Code to determine the enforceability of covenants against competition. Section 15.50 states:

(a) Notwithstanding Section 15.05 of this code, and subject to any applicable provision of Subsection (b), a covenant not to compete is enforceable if it is ancillary to or part of an otherwise enforceable agreement at the time the

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<sup>209</sup> *Howard v. Nitro-Lift Technologies, L.L.C.*, 273 P. 3d 20, 27 (Okla. 2011).

<sup>210</sup> Or. Rev. Stat. § 653.295.

<sup>211</sup> Or. Rev. Stat. § 646.461-646.475.

<sup>212</sup> S.C. Code § 39-8-30.

<sup>213</sup> S.D. Codified Laws § 53-9-8.

<sup>214</sup> S.D. Codified Laws § 53-9-9, 53-9-12.

<sup>215</sup> *Central Monitoring Serv., Inc. v. Zakinski*, 553 N.W. 2d 513, 516 (S.D. 1996).

agreement is made to the extent that it contains limitations as to time, geographical area, and scope of activity to be restrained that are reasonable and do not impose a greater restraint than is necessary to protect the goodwill or other business interest of the promisee.<sup>216</sup>

Section 15.51 specifies specific remedies and provides for court determined modifications to covenants (Tex. Bus. & Com. Code Ann. § 15.51 (West)) while section 15.52 establishes that the criteria laid out in section 15.05 “preempt any other criteria for enforceability of a covenant not to compete.” Tex. Bus. & Com. Code Ann. § 15.52 (West). See also *Butts Retail, Inc. v. Diversifoods, Inc.*,<sup>217</sup> (holding that 15.50 retroactively applies to breaches of franchise agreements).

## 15. Wisconsin

The Wisconsin Employment, Compensation and Mining Act allows for covenants against competition in employment contracts so long as they are “within a specified territory and during a specified time.”<sup>218</sup> Wisconsin state courts have not addressed the applicability of this statute in the franchise context, but a federal district court applying Wisconsin law found that a franchisee “is not an assistant, servant or agent of H & R Block for the purposes of Wis. Stat. § 103.465.”<sup>219</sup> The court in that case still enforced the covenant against competition against the former franchisee, but noted “[the] distinction [of applicable law] can be important, as the statute would void an entire restrictive covenant even if only part of the restraint was unreasonable ... [while] restraints governed by the common law analysis benefit from the rule of partial enforcement.”<sup>220</sup>

### C. State Antitrust Laws and Consumer Protection Statutes May be Interpreted to Apply to Covenants Against Competition

Some states have antitrust statutes that could be interpreted to invalidate covenants against competition in franchise agreements. For example, Arizona has an antitrust statute that states, “[a] contract, combination or conspiracy between two or more persons in restraint of, or to monopolize, trade or commerce, any part of which is within this state, is unlawful.”<sup>221</sup> On its face, this would appear to render void covenants against competition. However, the Supreme Court of Arizona has “found it necessary to interpret the statutory language in a somewhat looser fashion,” and thus allows covenants against competition in franchise agreements so long as they are ancillary to the sale of a business and reasonable in scope and duration.<sup>222</sup>

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<sup>216</sup> Tex. Bus. & Com. Code Ann. § 15.50.

<sup>217</sup> *Butts Retail, Inc. v. Diversifoods, Inc.*, 840 S.W. 2d 770 (Tex. App. 1992).

<sup>218</sup> Wis. Stat. § 103.465.

<sup>219</sup> *H & R Block E. Tax Services, Inc. v. Vorpahl*, 255 F. Supp. 2d 930, 935 (E.D. Wis. 2003).

<sup>220</sup> *Id.* at 933.

<sup>221</sup> Ariz. Rev. Stat. Ann. § 44-1402.

<sup>222</sup> *Three Phoenix Co. v. Pace Indus., Inc.*, 659 P.2d 1258, 1260 (Ariz. 1983).

Hawaii also has an antitrust statute that could be applied in the franchise context. Hawaii Revised Statutes section 480-4 states, “[every] contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce in the State, or in any section of this State is illegal.” However, it goes on to make the following exceptions:

(c)...it shall be lawful for a person to enter into any of the following restrictive covenants or agreements ancillary to a legitimate purpose not violative of this chapter, unless the effect thereof may be substantially to lessen competition or to tend to create a monopoly in any line of commerce in any section of the State:

(1) A covenant or agreement by the transferor of a business not to compete within a reasonable area and within a reasonable period of time in connection with the sale of the business;

(2) [Partnerships]

(3) [Lease agreements]

(4) A covenant or agreement by an employee or agent not to use the trade secrets of the employer or principal in competition with the employee’s or agent’s employer or principal, during the term of the agency or thereafter, or after the termination of employment, within such time as may be reasonably necessary for the protection of the employer or principal, without imposing undue hardship on the employee or agent.<sup>223</sup>

Section 480-4 has not yet been applied in the franchise context. In an employment case, the Supreme Court of Hawaii upheld a restrictive covenant but only after subjecting it to a ‘rule of reason’ test saying, “a covenant is valid only if the court deems it to be ‘reasonable’.”<sup>224</sup>

Nebraska also has a consumer protection statute that could be applied to covenants against competition in franchise agreements. Nebraska’s Consumer Protection Act states “[any] contract, combination, in the form of trust or otherwise, or conspiracy in restraint of trade or commerce shall be unlawful.”<sup>225</sup> The Supreme Court of Nebraska allows for covenants against competition so long as they are “reasonable in both space and time so that it will be no greater than necessary to achieve its legitimate purpose.”<sup>226</sup>

#### **IV. CONCLUSION AND PRACTICE POINTERS WHEN DRAFTING A NON-COMPETE PROVISION**

The enforceability of a covenant against competition is a state law issue. As a result, drafters must be aware of the various state laws that may come into play. For franchisor counsel, this means the law of the state chosen to govern the interpretation of the agreement, but it also means the laws of each state in which the franchisor is likely to sell franchises.

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<sup>223</sup> Haw. Rev. Stat. § 480-4.

<sup>224</sup> *Technicolor, Inc. v. Traeger*, 551 P.2d 163, 170 (Haw. 1976).

<sup>225</sup> Neb. Rev. Stat. § 59-1603.

<sup>226</sup> *H & R Block Tax Services, Inc. v. Circle A Enterprises, Inc.*, 693 N.W.2d 548, 550 (Neb. 2005).

Franchise counsel should therefore draft a clause with the strictest applicable state in mind to ensure that the covenant will be enforceable in all of the franchisor's markets.

Courts are increasingly likely to require precision in the wording of covenants against competition. The drafter's first job is to spell out the franchisor's legitimate business interests. Courts will generally recognize the need to protect the franchisor's interest in its brand, goodwill, reputation, and confidential information. These interests can be defined in the non-compete clause or elsewhere in the franchise agreement. Include a provision in which the franchisee acknowledges that it is receiving the franchisor's confidential information as part of the consideration for the franchise agreement. If a franchisee has acknowledged that a franchisor has certain legitimate, protectable business interests, then courts are more likely to enforce a non-compete clause against that franchisee.

Courts are more likely to uphold a narrowly crafted clause rather than a broadly worded clause, particularly when it comes to the scope of prohibited competition. The proscribed conduct should be related to the confidential information to which the franchisee had access as a result of the franchise relationship. Courts may be less likely to enforce a clause that simply prohibits a franchisee from operating any "similar business" than it would a clause that prohibits the franchisee from operating a similar business offering a menu made up of the same key components as the franchisor's using the same mode of service. For example, a high quality burger franchisor may want to prohibit franchisees from operating a "similar business in which more than 40% of the menu is comprised of high quality burgers being sold in a fast casual atmosphere."

Courts also require specificity in what roles the clause prohibits a former franchisee from taking on. The franchisor should specify what positions are prohibited and the list should only be as expansive as required to protect the franchisor's interest. Simply proscribing "any involvement" with a competing business is not satisfactory. Courts seek to balance the franchisor's interest in prohibiting unfair competition with the interests of the franchisee. If a clause is written to target certain competitive conduct while allowing a franchisee to make a living, the clause is more likely to withstand scrutiny.

In addition to defining specifically the competitive conduct that is "unfair" because it stems from the franchisee's access to confidential information, a franchisor can also reliably expect courts to enforce clauses that prohibit the solicitation of a franchisor's existing customers or that prohibit the solicitation of employees.

In crafting geographic restrictions, the franchisor should target a territory that is reasonably related to the franchisor's actual market area. Thus, for example, courts will generally enforce agreements that prohibit a former franchisee from competing within a certain radius of the franchisee's location as well as within a radius of any other existing franchisee. So long as the geographic scope is defensible as related to the franchisor's market area, courts will likely enforce the prohibition. This means there is no one-size fits all geographic territory for the enforceability of non-compete clauses.

Franchisors must also limit the duration of the covenant not to compete post-termination. The duration of the non-competition period must be reasonably related to the franchisor's interest in refranchising the territory. Generally, courts will consider a period of two years or less to be reasonable, but a shorter period may be advisable if a franchisor cannot justify a two-year time frame for re-franchising. Courts determine the reasonableness of the durational term



with an eye toward the franchisor's specific business interests rather than an objective standard for duration.

If a franchisor wishes to enforce the covenant by injunction, it is advisable to include a provision in which the franchisee expressly acknowledges that irreparable injury to the franchisor will ensue if the franchisee breaches the non-competition clause. Franchisors should also include an express acknowledgement that the clause survives expiration or termination of the franchise agreement and that a franchisor's alleged breach of the franchise agreement does not nullify the covenant against competition. Courts generally enforce such acknowledgements and this enables the franchisor to enforce the covenant even in litigation where the franchisee claims the franchisor breached the franchise agreement.

In order to bring non-signatories to the franchise agreement within the prohibitions against competition, franchisors should include language that expressly prohibits the franchisee as well as his or her "agents, servants, employees and others in active concert or participation with them" from the proscribed conduct. This type of language will be more successful than the more general "directly or indirectly" language in enforcing the covenant against non-signatories.

Franchisors will be more successful in enforcing non-competition clauses at the end of a franchise relationship if they carefully consider these issues at the front end when drafting the clause. Similarly, franchisees will be more successful in narrowing the reach of a non-competition clause if they address the scope of the clause through negotiation in advance of entering into the franchise agreement, rather than attempting to avoid enforcement at the end of the franchise term.

## **Nina Greene – Speaker Bio**

Nina Greene is a partner at the law firm of Genovese Joblove & Battista in Miami, Florida. She specializes in franchise, trademark and general commercial litigation. As a member of the Firm's franchise litigation practice, Ms. Greene has represented franchisors in litigation matters involving protection of trademarks and intellectual property rights, franchise terminations, racial discrimination claims, covenants not to compete, unfair competition, business torts and numerous other issues. She has represented franchisors in state and federal, trial and appellate courts in Florida and throughout the United States.

Prior to joining the firm, Ms. Greene served as a senior law clerk to the Honorable Robert N.C. Nix, Jr., Chief Justice of Pennsylvania. She is a member of the American Bar Association Forum on Franchising and Section of Litigation and the Florida Bar Association's Business Law Section, Antitrust, Franchise and Trade Regulations Committees. Ms. Greene is a member of the International Franchise Association Women's Franchise Committee and is also the co-chairperson for the South Florida Chapter of the Women's Franchise Network of the IFA. In addition, she is the co-advisory chairperson for Best Buddies in South Florida.

Ms. Greene has spoken on numerous franchise issues, including presenting the Judicial Update for the International Franchise Association's Legal Symposium, and has facilitated business solution roundtables on various franchise issues. She has co-authored an article for the American Bar Association Franchise Law Journal entitled "May a Franchisor Veto a Franchisee's Assumption of a Franchise Agreement in Bankruptcy?" Additionally, she has also co-authored franchise articles on "Frequently Arising Issues in Litigation" and "Franchise Defaults: Pulling the Trigger for 'Material' Defaults and Strategies for Strengthening Franchisor's Case." Ms. Greene has been named one of South Florida's "Top Lawyers" by the *South Florida Legal Guide* and has been recognized as one of the top franchise attorneys by *Franchise Times* magazine. In addition, Ms. Greene has been selected to appear in *Best Lawyers of America* and the "International Who's Who of Business Lawyers" and "International Who's Who of Franchise Lawyers."

Ms. Greene is a member of the Florida Bar and is admitted to practice before the United States District Courts for the Southern, Middle and Northern Districts of Florida and the United States Court of Appeals for the Fifth, Sixth and Eleventh Circuits. She earned her LL.M in Taxation from Temple University School of Law in 1997, Juris Doctor from the University of Miami School of Law in 1991 and her Bachelor of Arts from the University of Pennsylvania in 1988.

### **Ellen R. Lokker - Speaker Bio**

Ms. Lokker is the principal of Lokker Law PLC in Reston, Virginia. She is a frequent speaker and author on litigation and franchise-related topics. Ms. Lokker has been an active member of the American Bar Association (ABA). She served for ten years as an editor of the ABA's *Franchise Law Journal* and is a former vice chair of the ABA Antitrust Section's Distribution and Franchising Committee. Ms. Lokker was named a "Legal Eagle" by *Franchise Times* in 2007, 2008, 2009, and 2010 in recognition of her expertise and dedication to the practice of franchise law.

Ms. Lokker has extensive experience as a civil trial attorney representing corporations and individuals in franchise and general commercial litigation in federal and state courts and in arbitration proceedings. She regularly advises clients on franchise relationship issues and on the prevention and resolution of business disputes. She also concentrates on counseling start-up entities.

Ms. Lokker is an active member of the American Arbitration Association's (AAA) panel of commercial neutrals and its panel for large, complex commercial cases and frequently serves as an arbitrator of franchise and other business disputes.