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NEWSLETTER

Covenants Against Competition: Contractual Details—and the Facts—Matter

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Virtually every franchise agreement includes language restricting the franchisee's ability to operate in a business similar to the franchised concept both in-term and for a certain period of time after the agreement ends. In most (but not all) jurisdictions, courts will scrutinize the nature, extent, and duration of the restriction before enforcing a covenant against a franchisee, and are generally willing to enforce non-competition covenants if they are reasonable. Three recent cases illustrate the importance of carefully drafting covenant provisions in franchise agreements, and also being mindful from a practical perspective that even a well-drafted covenant may not be enforced in certain factual situations.

Overly Restrictive Covenant Not Enforced

In *Outdoor Lighting Perspectives v. Harders*, Bus. Fran. Guide ¶15,104 (N.C. Ct. App. Aug. 6, 2013), the North Carolina Court of Appeals upheld a trial court's determination that an outdoor lighting business franchisor could not enforce a post-termination covenant prohibiting a former franchisee from operating a competitive lighting business in a certain area for two years, finding the covenant to be overly restrictive. As a threshold matter, the court determined that it was appropriate, in evaluating the franchise agreement restriction, to use both the test utilized to analyze the enforceability of covenants in the sale of a business and the test utilized to analyze the enforceability of covenants in the employment context (with the latter covenants being more closely scrutinized than the former).

The portion of the covenant the franchisor sought to enforce prohibited the franchisee from operating a competitive business within the franchisee's former territory or that of the franchisor, its affiliates, or other franchisees. Noting that a restriction as to territory is only reasonable to the extent that it protects a legitimate interest in maintaining customers, the court found the geographic scope to be overbroad. The court was particularly troubled by language restricting the former franchisee's competitive activities in the territory of the franchisor's affiliates, noting that two of the affiliates (formed after the agreement date) were not even engaged in business related to outdoor lighting. As such, the court concluded that the geographic scope was broader than necessary to protect the franchisor, which could not show that it had a legitimate interest in prohibiting the franchisee's activities in areas in which neither franchisees nor the franchisor's affiliates were engaged in the outdoor lighting business. Similarly, the court determined that the definition of "competitive businesses" with which the former franchisee could not be involved was broader than necessary

to protect the franchisor's legitimate interests. Specifically, the expansive definition could preclude involvement with businesses not actually in competition with the outdoor lighting business of the franchise concept—for example, operation of a franchise that sold and maintained indoor lighting.

Injunction Enforcing Covenant Denied Where No Irreparable Harm Shown

In *Novus Franchising, Inc. v. Dawson*, Bus. Fran. Guide ¶ 15,110 (8th Cir. Aug. 5, 2013), the Eighth Circuit Court of Appeals upheld a lower court's refusal to issue a preliminary injunction against a former franchisee operating a competing business after the lower court concluded that the franchisor could not show irreparable harm. In upholding the lower court's ruling, the appellate court noted that the franchisor did not seek injunctive relief for nearly 18 months after the franchisee stopped paying royalties, which vitiated much of the force of its allegations of irreparable harm. The court also doubted that the injuries alleged by the franchisor—*e.g.,* a loss of customers or customer goodwill—could not be addressed through monetary damages if the franchisor was successful following a trial on the merits. Accordingly, the court determined that the district court did not abuse its discretion in refusing to issue an injunction enforcing the post-term covenant. In *Dawson*, therefore, it was not the language of the noncompete itself that was rejected; rather, the specific facts and timing of the case led the court to decline to enforce the clause, at least at the preliminary injunction stage.

Appropriately Tailored Covenant Reasonable and Enforceable

Finally, in *Jackson Hewitt, Inc. v. Dupree-Roberts*, Bus. Fran. Guide ¶ 15,108 (D.N.J. Aug. 7, 2013), a federal district court determined that a tax preparation business franchisor could enforce the post-termination noncompetition covenant against a former franchisee who was operating a competing tax preparation business at the location of one of her two former franchises, and was entitled to a default judgment enforcing the covenant. The court observed that New Jersey courts had not yet decided whether covenants not to compete in the franchise context were closer to agreements ancillary to the sale of a business or covenants in the employment context. Ultimately, the court concluded that the covenant at issue was reasonable even under the more stringent employment context standard.

In finding the covenant reasonable, the court noted that the covenant protected a legitimate interest of the franchisor in seeking to transfer customers of the former franchisee to other franchisees. The court further noted that the scope and duration of the covenant was not unreasonable or overly burdensome to the franchisee, who acknowledged in the agreement that she had “other skills, experience or education that will afford [her] the opportunity to derive income from other endeavors.” The scope and duration of the covenant also was found to be reasonable—the geographical range of the noncompete was restricted to five zip codes plus a 10-mile radius, and the restriction had a limited duration of two years. Finally, the court reasoned that there would be no public harm from enforcement of the covenant in light of the variety of tax preparation services available. Accordingly, the court held enforceable the “limited and circumscribed covenant,” and enjoined the franchisee from operating a competing tax business at the location of her former franchise (or otherwise within the geographic area covered by the covenant).

The Details—and the Facts—Matter

Courts frequently evaluate non-competes in the franchise context, and the above cases are but three examples of such common judicial analysis and what factors might make—or break—a case. While none of the cases are necessarily atypical or revolutionary, taken together, they serve as an important reminder of the various factors that are important in ultimately securing enforcement of a noncompetition covenant. So what lessons can franchisors take away? First and foremost, it is essential to closely scrutinize the language of a noncompete to ensure that it is no broader than necessary to protect legitimate interests—casting too wide a net geographically or temporally or imposing restrictions on more activity than necessary, as in *Harders*, may leave the franchisor with no protection if a court finds the covenant overly broad. Second, do not underestimate the importance of the facts. As the *Dawson* caseshows, a well-drafted covenant is necessary, but not necessarily sufficient, to secure an order restraining a former franchisee from engaging in competitive activities (at least at the preliminary injunction stage) if the franchisor fails to demonstrate any urgency in enforcing its rights. Ultimately, being mindful of the importance of both the particulars of the covenant and the specific facts at play should help franchisors be more successful in enforcing post-term contractual rights regarding franchisee competition.