Law on Covenants Against Competition Shifts Toward Greater Enforceability by Franchisors

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Most franchise agreements include a covenant obligating the franchisee not to operate or have an interest in another business similar to the franchised business. These covenants usually prohibit competition during the franchise term and for a period following the expiration or termination of the franchise agreement. They generally prevent the franchisee from competing at or within a specified radius of the franchise location or of other units operating under the franchise system's licensed marks.

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Unlike most contractual provisions, covenants against competition historically have been subject to a standard of "reasonableness" imposed by state public policy because they have the potential to restrain trade and to deprive a person of the ability to earn a living in his or her chosen field. At the same time, courts have long recognized that employers, buyers of businesses, and others may have legitimate interests in preventing employees, sellers of businesses, and independent contractors from engaging in competition that unfairly trades on benefits such as confidential information and goodwill that are shared, developed, or transferred ancillary to contractual relationships.

The enforceability of covenants against competition in franchise agreements is primarily a matter of state common law,[1] although some states have enacted statutes that govern the validity or enforceability of such covenants. Over the past thirty years,[2] many courts have broadened their view of the legitimate interests of a franchisor that are protected by franchisees' agreements not to compete and have expanded enforcement of such covenants accordingly. In some important instances, state statutes have directed or accelerated that process.

This article briefly summarizes the differing historical enforcement of covenants against competition in employment agreements, agreements for the sale of a business, and franchise agreements; discusses the evolution toward more liberal enforcement of those covenants in franchise agreements; surveys recent cases addressing in-term covenants not to compete in franchise agreements, which raise policy considerations different from those raised by post-termination covenants; and analyzes Georgia's recent statute designed to make it significantly easier to enforce covenants against competition under Georgia law.

Common Law Enforcement of Covenants Against Competition

Historical Enforcement of Covenants

Although restrictions on trade are disfavored, courts will enforce covenants against competition when they are necessary to protect a legitimate interest of the covenantee. Courts have enforced such covenants by sellers in agreements for the sale of a business for hundreds of years,[3] because they protect a buyer's investment in the business's goodwill and trade secrets, and therefore promote the transfer of property.

Courts have also enforced restrictive covenants in employment agreements, although less freely, because they recognize an employer's interest in retaining the customers served by its employees and in protecting confidential business information to which employees may have had access during their employment.[4] These interests justify restricting an employee's right to engage in a competing business for some period after the employment relationship ends, because the employer cannot maximize the employee's usefulness unless it can freely transfer confidential information and customer contacts to the employee, but the employer will be reluctant to do so unless it is able to prevent the employee from later using that information to compete against it.[5]

Traditionally, courts have subjected covenants not to compete in employment agreements to stricter scrutiny than that applied to covenants in agreements for the sale of a business.[6] A seller of a business receives consideration for the sale and thus is less likely to be rendered destitute by a covenant not to compete with the buyer. Moreover, a large part of what the seller is selling is the goodwill of the business, which could be quickly eroded if the seller were not prohibited from establishing a new business offering the same products or services to the same customers. Therefore, courts have been inclined to defer to the parties' judgment as to the appropriate scope of the prohibition on competition by a seller.

Employees, on the other hand, usually have less bargaining

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power in negotiating the scope of a non-competition agreement. They depend on their paychecks to support themselves and their families. Moreover, a former employee's ability to use trade secrets and customer contacts acquired during employment to compete with a former employer is necessarily circumscribed by the information the employee learned and the customers with whom the employee had contact. Thus, courts have tended to strictly scrutinize whether employee non-competition agreements are reasonably limited in time, geographic territory, and substantive scope.

Enforceability of Covenants Against Competition in Franchise Agreements

Like other covenants against competition, those in franchise agreements are subject to a standard of reasonableness because they have the potential to restrain trade or interfere with a franchisee's ability to find future employment. Nonetheless, most states will enforce a franchisee's covenant against competition to the extent the franchisor shows that legitimate interests support restricting the franchisee's ability to compete.

Most states consider similar elements in analyzing the enforceability of a franchisee's covenant not to compete. To be enforceable, the covenant must be ancillary to an otherwise lawful contract and must further the lawful goals of the contract.[7] In addition, the covenant must be necessary to protect a legitimate business interest of the franchisor; reasonable in scope with respect to the territory, time, and activities restrained; and not offensive to public policy.[8] The difference in the enforceability of these covenants in different states is generally a function of how narrowly the courts of a particular state interpret these general requirements and how strictly they scrutinize the parties' arguments that the requirements have been met.

A Move Toward Greater Enforcement of Franchise Covenants

In the early years of modern franchising, courts, with some exceptions, tended to analogize covenants against competition in franchise agreements to covenants in employment agreements.[9] As a result, those covenants had to be narrowly drawn to survive judicial scrutiny. In recent years, however, courts increasingly have analogized covenants in franchise agreements to covenants in agreements for the sale of a business or have created a test for enforceability that is specific and favorable to franchising. This has increased the likelihood that a franchisee's covenant not to compete will be found reasonable and, therefore, enforceable.

Courts Adopting the Sale of Business Analogy

In *Wilkinson v. Manpower, Inc.*, one of the earliest cases to analogize a covenant against competition given by a franchisee to a covenant given by the seller of a business, the Fifth Circuit simply found "no apparent rationale for distinguishing a franchise from the sale of a business."[10] Thus, although the *Wilkinson* decision provided a precedent, it gave little reasoning for other courts to consider.

Eight years later, another court likened a covenant given by a franchisee to one given by the seller of a business. In that case, *McCart v. H&R Block, Inc.*,[11] the Indiana Court of Appeals set out a substantive analysis for determining the enforceability of the franchisee's obligation not to compete:

> Block has a valuable property right in its service mark. The value is reflected by customers' name recognition and resultant use of the service offered under the Block name. [The franchisee] was willing to pay for that customer affiliation as would a buyer of a business. In return, Block gave [the franchisee] the right to use that service mark and benefit from the customers it drew as long as the contract terms were met. By including the covenant not to compete in the agreement, Block preserved the value of that property right to itself alone after the termination of the agreement.[12]

Nearly a decade later, in another seminal decision, *Jiffy Lube International, Inc. v. Weiss Brothers, Inc.*,[13] a federal district court in New Jersey provided a similar rationale for treating covenants in franchise agreements like those in the sale of a business. Without citing either *Wilkinson* or *McCart*, the court reasoned that a franchisee has more bargaining power than an employee and that the primary purpose of the franchise relationship is the purchase of a license conveying to the franchisee the right to use the franchisor's trademark to "trade upon and exploit the franchisor's good will."[14] The court stated:

> One can view a franchise agreement, in part, as a conveyance of the franchisor's good will to the franchisee for the length of the franchise. When the franchise terminates, the good will is, metaphysically, reconveyed to the franchisor. A restrictive covenant, reasonably crafted, is necessary to protect the good will after that reconveyance.[15]

Relying on these precedents, a number of recent decisions involving covenants contained in franchise agreements have adopted the sale of a business analogy. For example, a federal district court in Wisconsin found that a statute governing the enforceability of restrictive covenants in employment agreements did not apply to franchise agreements because the franchisee was not an assistant, servant, or agent of the employer.[16] In doing so, the court relied on the *Wilkinson* decision likening covenants in franchise agreements to covenants in agreements for the sale of a business.[17]

Other courts have focused on the transfer of goodwill to analogize covenants against competition in franchise agreements to those in agreements for the sale of a business.[18] For example, in *H&R Block Tax Services, Inc. v. Circle A Enterprises, Inc.*, the Nebraska Supreme Court analogized a restrictive covenant in a franchise agreement to one in the sale of a business because the main purpose of the agreement was to "trade on the reputation and goodwill of [H&R Block's] service mark and thereby acquire customers."[19] The court adopted that analogy even though it also noted that the franchisor retained significant control over its franchisees, an interest sometimes considered in analyzing restrictive covenants in employment agreements.[20] Following the approach taken in *McCart* and *Jiffy Lube*, the court recognized a franchisor's legitimate interest in protecting the customer affiliation and goodwill that are temporarily transferred to the franchisee under a franchise agreement and held that a covenant against competition was an appropriate means of achieving that protection.[21]

Finally, some courts have relied on prior cases applying the sale of a business analogy and have added other reasoning.[22] In *Boulanger v. Dunkin' Donuts, Inc.*, the Supreme Judicial Court of Massachusetts cited both *Wilkinson* and *Jiffy Lube* for the proposition that covenants against competition in franchise agreements are similar to those in the sale of a business.[23] The court then added its own reasoning. First, the court found that the franchisee was not an employee of the franchisor, relying on the franchisee's independent contractor classification in the franchise agreement and the fact that the franchisee paid a fee for the franchise and entered into the franchise agreement and ancillary restrictive covenant "with his eyes wide open."[24] Next, after noting that the franchisee received confidential information and the right to use the franchisor's trademarks, the court found that protection of the confidential information and the goodwill connected with the trademarks constituted legitimate business interests.[25] Thus, the court concluded it should analyze this covenant against competition as it would analyze a covenant given by the seller of a business.[26]

Courts Recognizing Franchising-Specific Interests

While some courts have moved toward analogizing covenants against competition given by a franchisee to those given by the seller of a business, others have maintained that neither the employment nor the sale of a business analogy is a good fit for the franchise relationship. One of the earliest examples is a 1965 decision in which the Fifth Circuit addressed a covenant not to compete in a Budget Rent-A-Car franchise agreement. Both parties and the trial judge tried to fit the covenant into either the sale of a business or the employment model, but the Fifth Circuit concluded that "realistically, it does not fit in either."[27]

Since then, other courts have noted the uniqueness of the franchise relationship and have recognized that the franchise itself constitutes a legitimate and protectable business interest.[28] This view led a Tennessee court to fashion a test for the enforcement of covenants specific to franchises.[29] In *Servpro Industries, Inc. v. Pizzillo*, the court recognized that the franchisor had a peculiar interest in protecting the value of the product it sold—its franchises.[30] In focusing on this interest, the court found that the restrictive covenant prevented the former franchisee from soliciting the franchisor's customers in the formerly franchised territory, which in turn made it easier for the franchisor to refranchise the territory.[31]

Some states directly apply a reasonableness test to covenants in franchise agreements rather than invoking an analogy to either an employment covenant or a covenant given in connection with the sale of a business. In doing so, they are able to consider franchise-specific interests, including some of those noted above. For example, New York courts have recognized that post-termination covenants in franchise agreements should be enforced when they are reasonably related to the protection of the franchisor's system and its ability to refranchise the territory formerly granted to the franchisee.[32] One federal court in New York observed that "[t]here is a recognized danger that former franchisees will use the knowledge that they have gained from the franchisor to serve its former customers, and that continued operation under a different name may confuse customers and thereby damage the good will of the franchisor."[33]

Similarly, courts applying Illinois law liken franchise agreements to licensor–licensee relationships when evaluating the enforceability of covenants not to compete entered into by a franchisee.[34] As a result, those courts also apply a reasonableness test.[35] For example, in *In re KBAR, Inc.*, the court recognized the franchisor's interest in protecting its confidential information, limiting the franchisee's use of training and knowledge gained as a franchisee, allowing time for the public to disassociate the franchisee from the franchisor, and refranchising the area formerly served by the franchisee.[36]

Some cases have recognized franchise-specific interests even when ostensibly applying a traditional framework. In *Economou v. Physician's Weight Loss Centers of America*, the court appeared to analyze the restrictive covenant in the franchise agreement like a covenant in an employment agreement, yet still stressed the franchisor's legitimate interest in protecting the goodwill generated by its system.[37] There, the court noted that "the franchisee has gained knowledge and experience from the franchisor, and to allow the franchisee to use this knowledge and experience to serve former or potential customers of the franchisor would work a hardship and prejudice to the latter."[38]

In *Baskin-Robbins Inc. v. Golde*, a federal district court in North Carolina relied on the reasoning of *Economou* and emphasized the franchisor's interest in protecting the value of the training franchisees received from their franchisor.[39] The court also noted the franchisor's interest in protecting its goodwill and preventing consumer confusion.[40] Finally, the court recognized the value other franchisees place on preventing former franchisees from unfairly competing with them and observed that protecting current franchisees from such unfair competition would strengthen the franchise system, serving the franchisor's legitimate business interests.[41]

Several other decisions have given weight to franchise-specific factors while applying the sale of a business framework.[42] For example, the court in *Jiffy Lube* noted the importance to the franchisor of uniformity in the enforcement of franchise agreements, so that franchisees would not get the message that they could "defraud with impunity."[43] The court in *Boulanger* noted that the restrictive covenant was designed in part to protect the very franchise system from which the franchisee benefited.[44] The *Boulanger* court also observed that, in entering into the franchise agreement, the franchisee received a long-term contract of association and protection from competition by former franchisees.[45] Thus, it held: "The system is reasonable because it binds all other franchisees and is part of what the defendant sells."[46]

In summary, whether by applying the sale of a business analogy, acknowledging interests unique to franchisors, or both, courts increasingly are recognizing the need for more liberal enforcement of covenants against competition in franchise agreements.[47] The transfer of goodwill is an important aspect of a franchise agreement, and a franchisor owns and ultimately regains possession of the trademarks and business system on which the goodwill is based. Thus, franchisors have a legitimate interest in ensuring that former franchisees will not be able to trade on goodwill developed under the franchisor's marks once the relationship ends. Moreover, other franchisees depend on the franchisor's enforcement of covenants not to compete. For those reasons, it is likely that the common law trend toward more liberal enforcement of covenants against competition in franchise agreements will continue.

Developments in the Enforcement of In-Term Covenants Against Competition

In both the franchise and non-franchise contexts courts have long drawn a distinction between in-term covenants not to compete (those that operate during the term of an agreement) and post-term covenants not to compete (which operate after the termination or expiration of an agreement). Traditionally, courts have subjected post-term covenants to stricter scrutiny than in-term covenants for numerous policy reasons. Chief among those reasons, as discussed above, is a public policy concern that post-term covenants against competition could constitute an unreasonable restraint of trade or interfere with a person's ability to make a living in his or her chosen field. As a result, courts have required post-term covenants to be narrowly tailored so that they limit competition only to the extent necessary to protect the legitimate business interests of the former employer, buyer of a business, or franchisor. On the other hand, courts typically have been less concerned with in-term covenants, especially those in franchise agreements,[48] because they are of limited duration, they protect the franchisee's loyalty to the franchisor and deter potential conflicts of interest, and they do not generally injure the public or inhibit the franchisee's ability to make a living.[49]

In the context of franchise agreements, courts have noted that in-term covenants not to compete are necessarily limited in duration—by definition they can last no longer than the term of the franchise agreement—and thus they do not raise the same concerns about "reasonable duration" as post-term covenants.[50] In addition, in some cases, the franchisee has the option of ending the franchise agreement (and in-term restrictions) at any time by terminating the agreement.[51] Moreover, courts have noted that striking an in-term covenant alters the parties' bargain by allowing a franchisee to continue to benefit from most provisions of the franchise agreement without having to comply with other obligations of the agreement, specifically the in-term covenant.[52]

Both in-term and post-term covenants against competition must be "reasonable" to be enforceable, but courts generally have applied less scrutiny in evaluating the reasonableness of in-term covenants. Courts have held that in-term covenants in franchise agreements are generally reasonable and valid because they have a "just and honest purpose" and are "not injurious to the public."[53] Courts also have explained that these in-term covenants are not unreasonable restraints of trade because the franchisor has a legitimate interest in protecting its business and the interests of its other franchisees against competition from a franchisee who is also operating a competing business.[54] Finally, some courts have supported the reasonableness of in-term covenants by noting that they help ensure a franchisee's loyalty to the franchise system during the term of the franchise agreement.[55]

Recent decisions have continued to find in-term covenants not to compete in franchise agreements to be reasonable and enforceable. But courts in at least two states, California and Georgia, have taken a stricter approach to in-term covenants, applying the degree of scrutiny traditionally reserved for post-term covenants.

Recent Decisions Upholding the Enforceability of In-Term Covenants

In *Anytime Fitness, Inc. v. Family Fitness of Royal, LLC*, the Minnesota federal district court entered a temporary restraining order against a franchisee for violating its in-term covenant against competition.[56] The franchisee had covenanted not to own or operate any other fitness center in a defined "protected territory" during the term of the franchise agreement. The franchisee later asked the franchisor for a written statement confirming that it "cannot and will not attempt to enforce its noncompetition clause." After the franchisor refused, the franchisee changed the name of one gym facility and began operating a competing gym while still maintaining three franchised gyms. In granting the franchisor's request for a temporary restraining order, the court explained the public policy reasons for enforcing in-term covenants and noted that courts uphold non-compete agreements during the term of a franchise agreement "when the need of the franchisor to protect and maintain its trademark, trade name and goodwill outweighs the franchisee's right to operate its business."[57] The court relied on both California and Minnesota law in holding that in-term covenants should be upheld when they are limited in scope.[58] The in-term covenant at issue was enforceable, the court held, because Anytime Fitness had business interests to protect, and the covenant was limited geographically to a single county.[59]

In *Keating v. Baskin-Robbins*, a federal district court in North Carolina upheld an in-term covenant against competition given by a Baskin-Robbins franchisee.[60] When the franchisee began selling another brand of ice cream at the store, Baskin-Robbins brought several claims, including breach of contract, and the franchisees claimed that the in-term covenant was invalid. The court rejected the franchisee's argument, noting that "it is beyond cavil that an ice cream franchise may reasonably require a franchisee not to operate a competing ice cream store during the term of its franchise agreement."[61]

While some courts have distinguished their analysis between in-term and post-term covenants, other courts have considered the "reasonableness" of the covenants together. In *Bonus of America, Inc. v. Angel Falls Services*, a federal court in Minnesota granted a preliminary injunction to stop a franchisee from operating a competing cleaning and maintenance business in violation of the franchise agreement's in-term covenant not to compete.[62] The covenant prohibited the franchisee from owning or operating any competitive business within fifty miles of the franchisor during the twenty-five-year term of the agreement and for two years post-term. The franchisor introduced evidence that the franchisees were operating a competing business and employing many of the same employees there. Without parsing the in-term and post-term portions in its opinion, the court applied Texas law to determine the enforceability of the covenant not to compete. The court held that the covenants were enforceable because they were limited in time, area, and scope of activity; were ancillary to the franchise agreement; and were designed to protect confidential information.[63]

Courts Finding In-Term Covenants Unreasonable

In *Comedy Club, Inc. v. Improv West Associates*, the Ninth Circuit modified an in-term non-competition provision of a licensing/franchise agreement.[64] Improv West, the founder of Improv Comedy Club, granted Comedy Club, Inc. (CCI) a twenty-year nationwide license to use the Improv marks in connection with the opening of new comedy clubs. In exchange, CCI agreed to open and develop four comedy clubs a year for the first three years of the agreement. The license agreement contained a provision preventing CCI from opening any other comedy club or any other club, bar, or restaurant anywhere in the United States.[65] After CCI failed to open the required number of clubs set forth in the development plan, Improv West sought to revoke the licensing agreement. In response, CCI sought a declaration that the covenant not to compete was void under California Business and Professions Code (CBPC) § 16600.

The Ninth Circuit, reviewing an arbitrator's decision upholding the covenant, held that under California law even in-term covenants cannot prevent a party from engaging in its business or trade in a substantial section of the market.[66] The court found that because the covenant prevented CCI from operating another club for fourteen years anywhere in the entire United States, it "foreclose[d] competition in a substantial share" and was thus invalid.

But the covenant was only partially invalidated.[67] Citing differences between franchising and employment, the court concluded that in a franchise context it would not be proper to void the entire in-term covenant.[68] Without any reference to the factual record, and without setting forth any clear judicial standards for doing so, the court modified the covenant by narrowing the geographic restriction from the entire United States to those counties where CCI already operated licensed comedy clubs.[69] The court stated that the franchisor's interest in protecting and maintaining its trademarks, trade names, and goodwill outweighed the franchisee's right to operate its business in those counties, but it did not explain why counties constituted a reasonable unit of geographic restriction for comedy clubs, which are rarely located in the same county.[70]

A recent decision by the Georgia Supreme Court, *Atlanta Bread Company International, Inc. v. Lupton-Smith*, also struck down an in-term non-compete provision. Georgia law at the time did not allow courts to modify an overbroad covenant, however, and thus the entire in-term provision was held invalid.[71] The covenant in *Lupton-Smith* prohibited the franchisee during the term of the agreement from "directly or indirectly engag[ing] in, or acquir[ing] any financial or beneficial interest in . . . any bakery/deli business whose method of operation is similar to that employed by store units within the [franchise] System."[72] After the franchisee opened a coffee shop and lounge that the franchisor alleged amounted to a bakery/deli with a similar method of operation, the franchisor terminated the franchisee for violating the in-term covenant.

Both the trial court and the Georgia Court of Appeals acknowledged that "the threat of a restrictive covenant regarding conduct during the term of a franchise agreement is not as great as a covenant regarding conduct following termination of the franchise agreement."[73] But the courts concluded that the in-term covenant should be evaluated under the same reasonableness standards as a post-termination covenant not to compete. The franchisor's covenant was unenforceable, the Georgia Court of Appeals held, because it failed to include a territorial limitation, failed to specify with particularity the nature and kind of business that would be competitive with the franchisor's business, and contained an overly broad activity limitation.[74]

The Georgia Supreme Court granted certiorari to determine whether the reasonableness standard applicable to post-termination restrictive covenants also applied to in-term restrictive covenants, and it answered that question in the affirmative. The court first declined to consider the clause a "loyalty provision" rather than a restrictive covenant, concluding that it was a "partial restraint of trade designed to lessen competition."[75] Then, without discussing the policy reasons that might support applying a different standard of reasonableness to evaluate in-term and post-term covenants, the court concluded that "there is no distinction to be made as to the level of scrutiny applied to a non-competition clause in a franchise or distributorship agreement based on its status as being active during the term of the agreement, and this Court declines to adopt a lesser standard of scrutiny."[76] The court then followed Georgia's traditional refusal to modify or "blue pencil" overly broad restrictive covenants to render them enforceable and instead held that the in-term covenant was unreasonable and thus unenforceable, because it lacked any territorial limitation.[77]

Luckily for Georgia-based franchisors, the *Atlanta Bread* opinion has been effectively reversed by a new Georgia statute addressing restrictive covenants.

Georgia's New Statute Makes it Easier to Enforce Restrictive Covenants

Georgia has long been recognized as a state that made it difficult to enforce restrictive covenants in employment and franchise agreements. On May 11, 2011, however, Georgia's governor signed into law a new state statute that reverses this long-held legal bias against enforcement of restrictive covenants and will make it easier to enforce such covenants under Georgia law.[78] The new statute was authorized by a state constitutional amendment passed by Georgia voters in November 2010.[79] It applies to all restrictive covenants entered into after May 11, 2011.[80]

The new statute represents a comprehensive rewrite of Georgia's restrictive covenant law. It applies to employment relationships, contracts for the sale of a business, and certain other types of commercial agreements, including franchise and distribution agreements.[81]

Under the new law, post-term covenants not to compete still must be reasonable in "time, geographic area, and scope of prohibited activities."[82] But the statute provides for certain presumptions as to the reasonableness of such restrictions:

- A time restraint of two years or less after termination is presumed reasonable for employees, and a restraint of three years or less after termination is presumed reasonable for franchise and distribution agreements.[83]
- A geographic restriction is presumed reasonable if it covers "the areas in which the employer does business at any time during the parties' relationship, even if not known at the time of entry into the restrictive covenant," as long as the total distance encompassed by the covenant also is reasonable, or the agreement lists particular competitors as prohibited employers for a limited period of time after termination, or both.[84]
- A restriction regarding the scope of prohibited activities will be presumed valid if "[t]he scope of competition restricted is measured by the business of the employer or other person or entity in whose favor the restrictive covenant is given."[85] Any description of prohibited activities that "provides fair notice of the maximum reasonable scope of the restraint" is sufficient, even if the description is generalized or could be stated more narrowly to exclude extraneous matters.[86]

A good faith estimate of the business activities or geographic areas that may be applicable at the time of termination is sufficient, with the covenant being construed at termination to cover only so much of the estimate as relates to activities actually conducted by the franchisor or employer.[87]

For in-term covenants not to compete, the statute applies the same presumptions of reasonableness for geographic territory and scope of prohibited activities as those in the post-termination non-compete clause.[88] But it provides for potentially broader enforcement of in-term covenants, recognizing the different policy issues underlying in-term and post-term covenants. The statute states that an in-term covenant not to compete "shall not be considered unreasonable because it lacks any specific limitation upon scope of activity, duration or geographic area so long as it promotes or protects the purpose or subject matter of the agreement or relationship or deters any potential conflict of interest."[89]

Thus, the statute potentially permits a franchisor to enforce an in-term non-compete clause with a broad, or even unlimited, geographic area and a broad scope of prohibited activity (perhaps limited at least by the scope of the business of the franchise system), as long as the franchisor can show that such a restriction promotes or protects the purpose and subject matter of the agreement and deters the franchisee from conflicts of interest. Franchisors may be able to make such a showing, for example, by citing the breadth of the franchisor's disclosure of information to the franchisees about the system's business methods and operations and the franchisor's interest in keeping franchisees focused on running their franchised businesses, and not competing businesses, during the term of their franchise agreements.

Although the new statute provides that "[a]ny restrictive covenant not in compliance with the provisions of this article is unlawful and is void and unenforceable,"[90] it also provides—in perhaps the most significant change of Georgia law—that a court may modify, or blue pencil, overly broad restrictive covenants to render them reasonable under the circumstances for which they were made.[91] Courts are not required to "blue pencil" covenants held to be overly broad, but they have the discretion to do so. The standards for exercising such discretion no doubt will be developed over time through the courts' decisions.

Georgia's new statute also permits non-solicitation clauses prohibiting franchisees or employees from soliciting a franchisor's or employer's customers, including "actively seeking prospective customers" with whom the franchisees had material contact during their franchise relationship for purposes of providing products or services competitive with those provided by the franchisor's business.[92]

The new statute also removes prior limits on the time after termination during which a franchisor or employer could prohibit disclosure or use of confidential information. Non-disclosure provisions now can be enforced for as long as the information remains confidential or a trade secret.[93]

Finally, the new statute requires a franchisor or employer seeking enforcement of a restrictive covenant to "plead and prove the existence of one or more legitimate business interests justifying the restrictive covenant."[94] A "legitimate business interest" is defined to include, without limitation, trade secrets, valuable confidential information, relationships with prospective or existing customers or vendors, and goodwill associated with a business.[95] If the franchisor or employer shows by prima facie evidence that its restraint complies with the provisions of the new statute, then the franchisee or employee has the burden of establishing that the restraint does not comply with such requirements or that the covenant is unreasonable.[96]

Franchisors drafting covenants against competition under Georgia law should consider the following practical pointers:

- State in the franchise agreement itself the legitimate business interests that justify the agreement's restrictive covenants. Such reasons may include protecting the franchisor's trade secrets and confidential information; protecting the goodwill of the franchise and franchise system; and, if applicable, protecting relationships with prospective and existing customers.

- Draft post-termination non-compete clauses to fall within the statutory presumptions of reasonableness for restrictions on time, territory, and scope of activities.
- Make sure that any broad in-term non-compete clause is accompanied by a description of how the restriction promotes or protects the purpose of the agreement or the franchise relationship and deters potential conflicts of interest on the part of franchisees.
- Do not be too greedy in drafting non-compete clauses. Remember that although the new statute permits courts to modify an overbroad covenant, it does not require them to do so. Judges may be reluctant to modify covenants if they conclude the franchisor did not even try to be reasonable in limiting the scope of the covenants.

Georgia's new statute will make it easier for franchisors and distributors (as well as employers) to enforce covenants not to compete and other restrictive covenants under Georgia law. But the verdict is still out on how far and how fast the courts will go in changing their interpretation of these provisions. Given the strict scrutiny that Georgia judges have applied for decades when reviewing non-compete and other restrictive covenants and the discretion that the new statute gives them, franchisors are still advised to exercise caution when drafting such provisions in franchise agreements governed by Georgia law.

Conclusion

Recent case law and statutory developments have favored the enforceability of covenants against competition in franchise agreements. This trend seems likely to continue in the future.

Endnotes

1. Although federal antitrust statutes theoretically apply, restrictions imposed on a franchisee in a franchise agreement ordinarily are considered vertical restraints, which are analyzed under the rule of reason. Because restrictive covenants in franchise agreements will seldom, if ever, perceptibly affect competition in a relevant market, they are rarely invalid under antitrust laws. *See* Robert W. Emerson, *Franchising Covenants Against Competition*, 80 Iowa L. Rev. 1049, 1052 (1995); Peter J. Klarfeld & Kathleen D. Kennedy, *Covenants Against Competition in Franchise Agreements*, 4 Franchise L.J. 3, 10 (1984).

2. This area of law has changed even since one of the authors of this article edited the last edition of the Forum's book on this subject. Peter J. Klarfeld, Covenants Against Competition in Franchise Agreements, at xvii (Peter J. Klarfeld, ed., 2d ed. 2003).

3. *See* Mitchel v. Reynolds, (1711) 24 Eng. Rep. (Q.B.), 347 1 P. Wms. 181 (enforcing a restrictive covenant ancillary to the sale of a business).

4. Harlan M. Blake, *Employee Agreements Not to Compete*, 73 Harv. L. Rev. 625, 653 (1960).

5. Restatement (Second) of Contracts § 188 cmt. b (1981).

6. *Id.*; *see* Keller Corp. v. Kelley, 187 P.3d 1133, 1138-39 (Colo. Ct. App. 2008) (collecting cases).

7. *Keller Corp.*, 187 P.3d at 1137; Restatement (Second) of Contracts § 187 cmt. b (1981).

8. *See, e.g.*, Piercing Pagoda, Inc. v. Hoffner, 351 A.2d 207, 211 (Pa. 1976).

9. *See, e.g.*, Watson v. Waffle House, Inc., 324 S.E.2d 175, 177 (Ga. 1985); Armstrong v. Taco Time Int'l, Inc., 635 P.2d 1114, 1117 (Wash. Ct. App. 1981) ("Courts agree a franchise agreement is akin to an employment contract."); H&R Block, Inc. v. Lovelace, 493 P.2d 205, 212 (Kan. 1971).

10. 531 F.2d 712 (5th Cir. 1976) (finding that the restrictive covenant would be enforceable under Wisconsin and Florida law).

11. 470 N.E.2d 756 (Ind. Ct. App. 1984).

12. *Id.* at 763–64.

13. 834 F. Supp. 683, 691 (D.N.J. 1993).

14. *Id.*

15. *Id.*

16. H&R Block E. Tax Servs. v. Vorpahl, 255 F. Supp. 2d 930, 934–35 (E.D. Wis. 2003).

17. *Id.*; *see also* H&R Block Tax Servs. LLC v. Kutzman, 681 F. Supp. 2d 1248, 1252 (D. Mont. 2010), *aff'd*, 373 Fed. App'x 797 (9th Cir. 2010) (relying on *Wilkinson* and analogizing the franchise agreement to the sale of a business for purposes of evaluating a franchisee's covenant not to compete under Montana law, in part because the franchisee retained control over the day-to-day operations of the franchised business).

18. Quizno's Corp. v. Kampendahl, No. 01 C 6433, 2002 U.S. Dist. LEXIS 9124, at *16 (N.D. Ill. May 20, 2002) (following the *Jiffy Lube* analysis and holding that the sale of a business exception in the Colorado statute prohibiting restrictive covenants applies to franchise agreements; also holding that the covenant protects trade secrets and is enforceable under the trade secret exception); Baskin-Robbins Inc. v. Golde, No. 5:99-CV-102-BR(3), 2000 U.S. Dist. LEXIS 22861, at *20 (E.D.N.C. May 25, 2000) (noting that the covenant was necessary to protect the goodwill of the business, which returned to the franchisor upon termination of the franchise, and finding this analogous to the interests protected by sale of business covenants); *Keller Corp*., 187 P.3d at 1139 (relying on the analysis of *McCart* and *Jiffy Lube* and finding that the franchise agreement constituted an agreement for the sale of a business); *see also* Furniture Medic, L.P. v. Jantzen., Bus. Franchise Guide (CCH) ¶ 12,749 (D. Ariz. Oct. 29, 2003) (quoting *Jiffy Lube*'s holding that a covenant in a franchise agreement should be analyzed in the same way as a covenant in an agreement for the sale of a business).

19. 693 N.W.2d 548, 556 (Neb. 2005).

20. *Id.* at 556.

21. *See Circle A Enters*., 693 N.W.2d at 555.

22. *See, e.g.*, Brenco Enters. v. Takeout Taxi Franchising Sys., No. 177164, 2003 Va. Cir. LEXIS 86, at *59 (Va. Cir. Ct. May 2, 2003) (finding no disparity in bargaining power between the parties and applying the standard used to analyze restrictive covenants in the sale of a business to a covenant in a franchise agreement).

23. 815 N.E.2d 572, 578 (Mass. 2004).

24. *Id.*

25. *Id.*

26. *Id.*

27. Budget Rent-A-Car Corp. v. Fein, 342 F.2d 509, 516 (5th Cir.

Ga. 1965). Although some of the interests recognized by courts in the employment and sale of business contexts may apply to franchise agreements, the latter are distinct in some important respects. Employment relationships may involve a transfer of the company's goodwill to the employee, but such a transfer is only incidental. In a franchise relationship, the transfer of goodwill is the primary purpose of the parties' agreement. Similarly, the parties intend for the franchisee to benefit from use of the franchisor's trade secrets and methods of operation. Franchisees, unlike employees, are expected to make a substantial capital investment at the start of a relationship and may recoup none of this capital investment when the franchise relationship ends. Franchise relationships often last for decades and involve active oversight of the franchisees' operations by the franchisor. By contrast, when a business is sold, the parties typically have no ongoing relationship. Furthermore, the competitive activities of former franchisees directly affect the interests of current franchisees. Indeed, part of the benefit for which franchisees bargain is the protection that restrictive covenants afford against competition from former franchisees. These differences suggest additional interests courts should consider in deciding whether to enforce a covenant not to compete in a franchise agreement. *See, e.g.*, Emerson, *supra* note 1, at 1052; *see also* Klarfeld & Kennedy, *supra* note 1, at 6; Klarfeld, *supra* note 2, at xvii.

28. Shakey's Inc. v. Martin, 430 P.2d 504, 509 (Idaho 1967) (citing *Fein*); *see also* Piercing *Pagoda*, 351 A.2d at 211 ("While a mere manner of doing business is not sufficient to constitute a protectable interest, which will sustain a covenant not to compete, the existing franchise itself is a legitimate business interest and therefore protectable."); *Taco Time*, 635 P.2d at 1119 ("[E]ven though a franchisor has no protectable interest in a method or style of doing business, it does have a legitimate interest in protecting the basic product it has to sell—its franchise." (citing *Shakey's* and *Piercing Pagoda)*).

29. *See* Servpro Indus., Inc. v. Pizzillo, No. M2000-00832-COA-R3CV, 2001 Tenn. App. LEXIS 87, at *19 (Tenn. Ct. App. Feb. 14, 2001) (citing *Shakey's*).

30. *Id.*; *see also Furniture Medic*, Bus. Franchise Guide (CCH) ¶ 12,749 ("A franchise is a valuable commodity which can only be protected by enforcing non-compete agreements." (citing *Servpro*)).

31. *Servpro*, 2001 Tenn. App. LEXIS, at *19–20; *see also Piercing Pagoda*, 351 A.2d at 212 ("The covenant faces the economic reality that continued operation of the appellants' stores subsequent to the termination of the agreement would adversely affect the ability of the franchisor to secure another franchisee in the same territory.").

32. Singas Famous Pizza v. New York Adver., No. 10 Civ. 8976 (RJH), 2011 U.S. Dist. LEXIS 14524, at *19 (S.D.N.Y. Feb. 14, 2011); ServiceMaster Residential/Commercial Servs., L.P. v. Westchester Cleaning Servs., Inc., No. 01 Civ.2229 (JSM), 2001 U.S. Dist. LEXIS 4807, at *9 (S.D.N.Y. Apr. 19, 2001); DAR & Assocs. v. Uniforce Servs., Inc., 37 F. Supp. 2d 192, 198–99 (E.D.N.Y. 1999) (citing *Piercing Pagoda*); *see also* Jiffy Lube Int'l, Inc. v. Weiss Bros., Inc., 834 F. Supp. 683, 691 (D.N.J. 1993) (noting that the franchisor "has an interest in being able to place a new franchisee at or near the same location where this good will has been created").

33. *ServiceMaster*, 2001 U.S. Dist. LEXIS 4807, at *9–10; *see also Singas Famous Pizza*, 2011 U.S. Dist. LEXIS 14524, at *19 (quoting and applying *ServiceMaster*).

34. *In re* KBAR, Inc., 96 B.R. 158, 160 (Bankr. C.D. Ill. 1988) (citing *In re* Talmage, 758 F.2d 162, 165 (6th Cir. 1985) (applying a reasonableness standard to a covenant not to compete contained in a license agreement)).

35. *Id.* at 160.

36. *Id.*

37. Economou v. Physician's Weight Loss Ctrs. of Am., 756 F. Supp. 1024, 1032 (N.D. Ohio 1991).

38. *Id.*

39. *Golde*, 2000 U.S. Dist. LEXIS 22861, at *13–14.

40. *Id.* at *15, 18.

41. *Id.* at *17 n.4.

42. *See, e.g.*, *Takeout Taxi*, 2003 Va. Cir. LEXIS 86, at *59 (recognizing all of the differences highlighted in note 28, *supra*, and citing Emerson, *supra* note 1, and *Fein*); *see also Singas Famous Pizza*, 2011 U.S. Dist. LEXIS 14524, at *19.

43. Jiffy Lube Int'l, Inc. v. Weiss Bros., Inc., 834 F. Supp. 683, 692–93 (D.N.J. 1993); *see also* ATL Int'l Inc. v. Baradar, Bus. Franchise Guide (CCH) ¶ 11,345 (D. Md. Nov. 12, 1997); Boulanger v. Dunkin' Donuts Inc., 815 N.E.2d 572, 693 (Mass. 2004).

44. *Boulanger*, 815 N.E.2d at 574.

45. *Id.* at 578.

46. *Id.* at 581. *Boulanger* also cited Casey's Gen. Stores, Inc. v. Campbell Oil Co., 441 N.W.2d 758, 761 (Iowa 1989), which found that "[n]oncompetition agreements between a franchisor and a franchisee are designed not only to protect the interests of the immediate parties but also to protect other franchisees against competitive activities. Thus, to the extent that such non-competition agreements are exacted from all franchisees, each franchisee is thereby protected from competition from other franchisees."

47. Some courts have continued to analogize covenants against competition in franchise agreements to those in employment contracts, of course, but we know of no cases in which a court reverted to the employment analogy after using a more liberal standard.

48. Orthopedic Equip. Co. v. Streetman & Assocs., Inc., 390 So. 2d 134 (Fla. Dist. Ct. App. 1980) (holding that an in-term covenant does not "create the evils which made post-term restraint invalid at common law.").

49. *See, e.g.,* Deutchland Enters. v. Burger King Corp., 957 F.2d 449, 453 (7th Cir. 1992) (finding it "essential and reasonable . . . for a fast food chain to prohibit franchisees from operating its restaurants and those of its competitors"); Adcom Express, Inc. v. EPK, Inc., No. C6-95-2128, 1996 Minn. App. LEXIS 615, at *10–11 (Minn. Ct. App. May 21, 1996) (enforcing two different in-term non-compete covenants, noting that "in-term covenants are impliedly limited to the term of the franchise agreement, protect confidential information, and ensure franchisee's loyalty to the franchise"); Dayton Time Lock Serv., Inc. v. Silent Watchman Corp., 124 Cal. Rptr. 678, 681-682 (Cal. Ct. App. 1975) (affirming order that in-term covenant in franchise agreement, unlimited in territorial scope, did not violate California competition statute or antitrust laws).

50. McDonald's Sys., Inc. v. Sandy's Inc., 195 N.E.2d 22 (Ill. App. Ct. 1963) (explaining that there is nothing illegal about an in-term covenants when the franchisee will be free to engage in similar business elsewhere upon termination of the agreement).

51. *Deutchland Enters.,* 957 F.2d at 453; *Adcom Express,* 1996 Minn. App. LEXIS 615, at *10–11.

52. *McDonald's*, 195 N.E.2d at 27–28.

53. *Adcom Express,* 1996 Minn. App. LEXIS 615, at *10–11.

54. *Id.*

55. *Id.* (enforcing two in-term non-compete covenants and explaining that the in-term covenants help ensure franchisees' loyalty to the franchise); *see also* Major v. Orthopedic Equip. Co., 496 F. Supp. 604, 606, 614 (E.D. Va. 1980) (holding in-term non-competition and best efforts covenant did not violate public policy as hospital supply company "undoubtedly has a legitimate interest in requiring [its distributor] to devote his fullest efforts to the promotion of [supplier's business]").

56. Anytime Fitness, Inc. v. Family Fitness of Royal, LLC, No. 09-3503, 2010 U.S. Dist. LEXIS 1583, *1 (D. Minn. Jan. 8, 2010).

57. *Id.* at *10 (quotations omitted) (citing Comedy Club, Inc. v. Improv Assocs., 553 F.3d 1277, 1291–94 (9th Cir. 2009).

58. *Id.* at *10–11.

59. *Id.*

60. Keating v. Baskin-Robbins, No. 5:99-CV-148, 2001 U.S. Dist. LEXIS 26328, *1 (E.D.N.C. Mar. 27, 2001) (holding that the franchisee's actions breached the in-term non-compete covenant).

61. *Id.* at *40. *See also* Coldwell Banker Real Estate v. Brian Moses Realty, 752 F. Supp. 2d 148, 162-63 (D.N.H. 2010) (granting summary judgment to Coldwell Banker on its claim that franchisee violated an in-term non-compete clause by opening an office associated with Re/Max).

62. Bonus of Am., Inc. v. Angel Falls Servs., LLC*,* No. 10-2111, 2010 U.S. Dist. Lexis 67079, *1 (D. Minn. July 6, 2010).

63. *Id.* at *12–13.

64. Comedy Club, Inc. v. Improv Assocs., 553 F.3d 1277 (9th Cir. 2009.

65. *Id.* at 1281, n.3.

66. *Id.* at 1292–93.

67. *Id.*

68. *Id.* at 1293.

69. *Id.*

70. *Id*. In *Big O Tires, LLC v. Feliz Bros., Inc.*, 724 F. Supp. 2d 1107, 1117–22 (D. Colo. 2010), the district court cited to the *Comedy Club* case while denying a franchisor's motion seeking to preliminarily enjoin a franchisee from violating an in-term non-compete clause by operating a competing tire store. The court found that the franchisor had not satisfied its burden of proving irreparable harm, where there was no evidence that the franchisee was diverting customers or using information from the franchised business to gain a competitive advantage. *Id*. at 1119–20. The court chose not to address the merits of the claim for breach. *Id*. at 1121.

71. Atlanta Bread Co. Int'l v. Lupton-Smith, 679 S.E.2d 722 (Ga. 2009) (*Atlanta Bread II*). One of the authors, Mark VanderBroek, represented Atlanta Bread Company in this case after it was remanded from the Georgia Supreme Court.

72. *Id.* at 723.

73. Atlanta Bread Co. Int'l v. Lupton-Smith, 663 S.E.2d 743, 746 (Ga. Ct. App. 2008) (*Atlanta Bread I*).

74. *Id.* at 747-48.

75. *Atlanta Bread II*, 679 S.E.2d at 724.

76. *Id.* at 725.

77. *Id.*

78. The new law modified Ga. Code Ann. § 13-8-2(a) to permit contracts "which restrict certain competitive activities," and enacted a new restrictive covenant statute at Ga. Code Ann. § 13-8-50 *et seq.*

79. The constitutional amendment gave the Georgia legislature the power to "authorize and provide by general law for judicial enforcement of contracts or agreements restricting or regulating competitive activities" between or among employers and employees, sellers and purchasers of a business, and those in certain other commercial arrangements including franchise and distribution agreements; and to permit courts to limit the scope of a restrictive covenant to render the agreement "reasonable under the circumstances for which it was made." Ga. Const., Art. III, § VI, ¶ V.

80. The new Georgia statute is virtually identical to a statute passed by the Georgia legislature in 2009, to become effective conditioned upon the voter's approval of the November 2010 constitutional amendment. After the constitutional amendment was approved, a technical issue arose as to the validity and effective date of the 2009 legislation. Without admitting that the 2009 legislation was invalid, the Georgia legislature in 2011 passed a virtually identical version of the statute. The new law applies to agreements entered into after May 11, 2011. The 2009 version may apply to agreements entered into between November 2010 and May 11, 2011, subject to court determination.

81. Ga. Code Ann. § 13-8-52. In the employment context, the statue applies only to executive employees, research and development personnel, or others who possess confidential information important to the business of the employer, and any other person or entity possessing "selective or specialized skills, learning, or abilities or customer contacts, customer information, or confidential information" obtained by having worked for an employer. *Id.* § 13-8-51(5).

82. *Id.* § 13-8-53(a).

83. *Id.* § 13-8-57(b), (c). A post-termination non-compete period of up to five years is presumed reasonable in connection with the sale of a business. *Id.* § 13-8-57(d). As Georgia's new statute applies somewhat different standards for franchisor-franchisee contracts, Georgia, like the states discussed in the previous section, has acknowledged that a franchise relationship differs from both an employment relationship and a sale of business transaction.

84. *Id.* § 13-8-56(2).

85. *Id.* § 13-8-56(3).

86. *Id.* § 13-8-53(c)(1). Furthermore, activities, products, or services "shall be considered sufficiently described if a reference to the activities, products, or services is provided and qualified by the phrase 'of the type conducted, authorized, offered, or provided within two years prior to termination' or similar language containing the same or a lesser time period." *Id.* § 13-8-53(c)(2).

87. *Id.* § 13-8-53(c)(1).

88. *Id.* § 13-8-56(2) and (3).

89. *Id.* § 13-8-56(4).

90. *Id.* § 13-8-53(d).

91. Ga. Const., Art. III, § VI, ¶ 5; Ga. Code Ann. §§ 13-8-53(d), 54(b).

92. Ga. Code Ann. § 13-8-53(b).

93. *Id.* § 13-8-53(e). The act includes, at Ga. Code Ann. § 13-8-51(3), a definition of "confidential information" that is similar to Georgia's statutory definition of a trade secret in Ga. Code Ann. § 10-1-761.

94. *Id.* § 13-8-55.

95. *Id.* § 13-8-51(9).

96. *Id.* § 13-8-55.