CARLTON FIELDS

# The Enforcement of Covenants Against Competition

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By: Jason Murray and Michael R. Gray As with any business venture, franchise arrangements have the potential for breakdown and termination. When this happens, the franchisor finds itself faced with a number of significant problems. First, the franchisor has commonly allowed its name and trademarks and service marks to be associated with the franchisee. How can the franchisor prevent the franchisee from continuing to operate under its name and marks? It has likely trained the franchisee in its methods and processes and made the franchisee privy to its confidential business information and trade secrets. What can the franchisor do to prevent the franchisee from using this knowledge to compete with it? Finally, what of the customers and goodwill generated for the franchisee through its affiliation with the franchisor? Non-compete agreements are one of the best means available to a franchisor to protect its interest in its trademarks, service marks, trade secrets, processes and other confidential business information. Although money damages remain available to compensate a franchisor for the wrongful use of these assets by a former franchisee, establishing an appropriate amount of damages can be difficult. By preventing the franchisee from wrongfully using these assets in the first place, a franchisor can better-serve its long-term interests and preserve its goodwill, name recognition, the integrity of its trademarks and service marks, and its market share, while stopping competition from the franchisee made possible by the franchisor's own training and business methods. Accordingly, most franchise agreements today contain some form of "non-competition clause," "covenant not to compete," "restrictive covenant," or some other form of agreement by the franchisee "not to compete with the franchise system it is entering, either during the term of the franchise agreement or for a period following termination of the agreement, or both." The enforcement of covenants against competition is principally a matter of state contract law and increasingly these provisions are regulated by state statutes. The Restatement (Second) of Contracts, a guide for many state courts and legislatures, provides: "1) A promise is unenforceable on grounds of public policy if it is unreasonably in restraint of trade. 2) A promise is in restraint of trade if its performance would limit competition in any business or restrict the promisor in the exercise of a gainful occupation." Under the Restatement (Second) of Contracts, a covenant not to compete that is ancillary to an otherwise valid transaction or relationship is valid and enforceable if the covenant is

necessary to further the legitimate goals of the contract and the covenant is “reasonable” as to the covered activities, time and geographic scope. Although the law governing the validity and enforceability of non-compete covenants in franchise agreements is characterized by its diversity among the states, most courts will hold a non-compete covenant to be valid and enforceable if it is: “(1) ancillary to an otherwise enforceable contract; (2) based on valuable consideration; (3) reasonable both as to time and territory in protecting the franchisor’s interests; and (4) not against public policy.” The test adopted by most courts and legislatures is very similar to the standard announced in the Restatement (Second) of Contracts. Because non-compete agreements in the franchise context are usually ancillary to the franchise agreement itself, the first and second prongs of the “enforceability test” are easily met. A determination of whether the third and fourth prongs of the test have been satisfied must begin with an examination of the legitimate interests that support enforcement of a covenant against competition in the franchise context.