Covenants Not to Compete and Nonsignatories: Enjoining Unfair Conspiracies

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Most franchise agreements today contain some form of noncompetition clause, covenant not to compete, restrictive covenant, or other 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."[1] These noncompete 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.[2] By preventing the franchisee from wrongfully using these assets, a franchisor can serve its long-term interests; preserve its goodwill, name recognition, market share, and the integrity of its trademarks and service marks; and protect its other franchisees while stopping competition from the franchisee made possible by the franchisor's own training and business methods.

Enjoining Nonsignatories

A franchisor's attempts to enforce covenants against competition are not always limited to parties that have signed the franchise agreement. In many instances, a spouse, child, parent, sibling, or family member may be involved in competitive activities after termination of the franchise relationship. The scenario is relatively common: the franchise agreement expires or is terminated, and shortly thereafter a competitive business springs forth at the same location as the former franchise. Upon investigation, the franchisor learns that the former franchisee's wife, son, daughter, father, mother, brother, sister, cousin, in-law, business partner, or other distantly related individual or entity is operating the business while claiming no affiliation with the former franchisee. Often there is no documentation between the former franchisee and the current operator of the business. In most instances, the new business is using the same premises and the same assets and serving the same customers as the former franchisee. Faced with these circumstances, many franchisors question whether they have any ability to enforce the post-termination noncompete agreement against the current operator who did not sign the franchise agreement.

Is the franchisor really trying to enforce the terms of the franchise agreement against a stranger to the contract when it attempts to enjoin the operation of a competitive business by nonsignatories following termination of the franchise agreement? Not really. It is a fundamental principle of contract law that contracts are not enforceable against individuals or entities who did not agree to be so bound.[3] Seeking to enforce a written contract against someone who did not sign it is a recipe for failure.

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Instead, the franchisor should focus on whether its former franchisee, a signatory of the franchise agreement, has breached the terms of the agreement and whether anyone else has aided, assisted, or participated in the breach. Although a court may not be able to enforce the written contract against nonsignatories, a court can enjoin individuals and entities from engaging in activities that constitute a conspiracy to breach the franchise agreement's covenant not to compete, "which is, in effect, a conspiracy for unfair competition."[4] The conspiratorial act of aiding and abetting the former franchisee's breach of the franchise agreement is the critical element that provides the basis for seeking equitable relief against nonsignatories who aid, facilitate, or participate in the former franchisee's violation of the franchise agreement's post-termination covenant not to compete.

Three Keys to Success

There are three keys to enjoining nonsignatories to a franchise agreement from conspiring with a former franchisee to operate a competitive business in violation of the agreement's post-termination covenant not to compete. First, the franchisor must establish that the former franchisee has breached the noncompetition provisions of the franchise agreement. Second, the franchisor must establish that the entity or individual who is operating the competitive business conspired, acted in concert, or aided and abetted the franchisee's breach of the agreement. Third, although not always necessary, a familial or close relationship substantially increases the odds of success.

McCart v. H&R Block, Inc.

One of the most-often-cited cases that demonstrate these truths is *McCart v. H&R Block, Inc.*[5] Robert and June McCart were accountants living in Rochester, Indiana. Robert signed a franchise agreement with H&R Block in 1968. Several years later he became a district manager for H&R Block, thereby precluding his owning a franchised location. Consequently, he assigned the franchise to his wife, June McCart. June signed a new franchise agreement with H&R Block in 1975. In 1981, June gave H&R Block notice that she was canceling her franchise agreement for health reasons. Shortly thereafter, June sent a letter to all of her H&R Block customers informing them that she was canceling her contract with H&R Block because of increased fees charged by the franchisor. She also stated, "I will assist my husband in his tax service in the future."[6] In the same envelope with June's letter was a letter written by Robert, wherein he announced that he would be opening a tax preparation office under the name Community Tax Service. Robert assured the customers that they, he and June, would continue to offer the same service at the same location with the same personnel. Shortly thereafter, H&R Block sought and obtained an injunction against Robert and June McCart restricting them from providing tax preparation services for two years within a fifty-mile radius of their former location.

On appeal, Robert argued that he should not be bound by the restrictive covenant because he did not sign the 1975 franchise agreement. The Indiana Court of Appeals disagreed. The court engaged in a thoughtful analysis of H&R Block's protectable interest in the goodwill associated with its trademarks and business system. The court also acknowledged the exchange of value in allowing the McCarts to use the H&R Block name "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."[7] The court expressly approved the findings of the lower court that Robert conspired with June to breach the terms of the franchise agreement and trade upon the going concern value, goodwill, and national advertising efforts of H&R Block.

After reviewing numerous cases throughout the United States involving the enforcement of noncompete agreements against nonsignatories, the court found that enforcement "does not rest upon the existence or nonexistence of the contractual relationship between Robert McCart and H&R Block." Robert and June McCart's "cooperative conduct amounted to a mere subterfuge designed to avoid June's obligations under the contract."[8] The *McCart* case is an excellent example of a franchisor's use of the keys for successfully enjoining nonsignatories to a franchise agreement from conspiring with a former franchisee to operate a competitive business in violation of the agreement's post-termination covenant not to compete.

Liability as a Successor

A more recent case involving the same franchisor is *H&R Block Tax Services, Inc. v. Sheets*.[9] Letha Sheets operated an H&R Block franchise business in West Liberty, Kentucky. She was also a shareholder and officer of Sheets Bookkeeping, Inc. ("SBI"), along with her daughter Jennifer Sheets. SBI provided bookkeeping, but not tax preparation, services. In August 2005, Letha gave H&R Block notice that she did not intend to renew her franchise agreement when it expired on December 18, 2005. H&R Block acknowledged the expiration of her franchise agreement and on December 19 entered into a new franchise agreement with another person to refranchise the West Liberty market.

Immediately after the franchise agreement expired, SBI began operating a tax preparation service from the same location as Letha's former H&R Block business, using the same employees, equipment, and telephone number. Letha claimed that she retired from SBI and was no longer a shareholder. On January 6, 2006, Jennifer and SBI sent a letter to "our clients" advising them that Jennifer Sheets and SBI were continuing to offer the same tax preparation services that they had offered as H&R Block, that they had all of the clients' personal information, and that the same tax preparers were available to perform tax preparation services for former H&R Block clients. The letter was sent to nearly 1,000 clients who had received tax preparation services from Letha's former H&R Block franchise in 2005. Letha also kept H&R Block's confidential information, including a hard copy of customer files, customer lists, customer names, and tax returns, all of which were readily available to Jennifer in an unlocked file cabinet in the SBI offices.

"Merely a Continuation"

H&R Block sought an injunction to enforce the noncompete and nonsolicitation provisions of the franchise agreement against Letha, Jennifer, and SBI. As nonsignatories, Jennifer and SBI claimed that they were not bound by the terms of Letha's franchise agreement with H&R Block. In analyzing H&R Block's motion, the court focused on successorship law and found that SBI was "merely a continuation" of Letha's H&R Block franchise.[10] SBI and Jennifer were performing the same services for the same customers from the same location with the same employees, using the same telephone number and the same assets as Letha's former H&R Block franchise. In addition, Jennifer's direct solicitation of former H&R Block customers expressing an intent to continue to prepare tax returns as she and SBI had done "in the past" demonstrated a strong likelihood of success on the merits of H&R Block's claim that SBI was "merely a successor," justifying injunctive relief.

The court enforced the noncompete agreement against Jennifer and SBI, as successors to Letha's H&R Block franchise. The court found that Jennifer knew of her mother's contractual obligations with H&R Block and actively assisted in the breach of those obligations, including the noncompetition and nonsolicitation provisions. Finally, the court found that client trust and goodwill earned by H&R Block would be irretrievably lost unless the defendants were enjoined. The court enjoined Letha, Jennifer, and SBI from operating a business

Practice Pointer

To enjoin nonsignatories to post-termination agreements, franchisors must:

- **Establish that the former franchisee has breached the noncompete provisions; and**
- **Establish that the former franchisee acted in concert, aided, or abetted the competitive business.**

A family or other close relationship increases the franchisor's odds of success.

preparing tax returns or performing related services within forty-five miles of West Liberty.

Nonparty's Close Relationship

Gold Messenger, Inc. v. McGuay[11] is another example of the keys necessary to enjoin a nonparty. In *Gold Messenger,* an advertising circular franchisor brought an action to enjoin the life partner of the former franchisee from operating a competitive advertising circular business after termination of the franchise agreement. Although the life partner did not sign the franchise agreement, he did operate the franchise with the franchisee for at least two years, during which time they were both trained by the franchisor and had access to the franchisor's trade secrets. The former franchisee's life partner argued that, notwithstanding the existence of potential trade secrets, the noncompete agreement should not be enforced against him because he did not sign the franchise agreement. The court disagreed, finding that "a nonsignatory may be bound by a covenant not to compete based on his or her particular relationship to a business."[12]

Citing the *McCart v. H&R Block* case, the court also found that a third party is bound by the covenant "at least to the extent that he or she assists the covenantor to violate the covenant not to compete."[13] Finally, the court enjoined the defendant because "a covenantor will not be allowed to do through others what he or she could not do directly." In *Gold Messenger,* the court found significant that the former franchisee's life partner successfully produced competing publications that were quite similar to the franchisor's publications shortly after termination of the franchise agreement. Although not expressly stated, the fact that both the former franchisee and the defendant operated the business prior to the termination of the franchise agreement and their close personal relationship most likely contributed to the court's decision.

Use of Corporate Shield

In *Total Car Franchising Corp. v. L&S Paintworks, Inc.,*[14] the franchisee was a Tennessee corporation operated by James Lunsford. The post-termination noncompete provision in the franchise agreement applied to the corporate franchisee, L&S Paintworks, Inc., as well as its "partners or shareholders." After L&S Paintworks operated the business for two years, the franchisor terminated the franchise agreement. Shortly thereafter, Lunsford began providing competitive services under the name Pro Touch Auto Services. The franchisor sought an injunction against Lunsford and Pro Touch Auto Services. The court found that Lunsford was the proprietor of the former franchisee, L&S Paint Works, Inc., and that he was one of just two owners of the former franchisee who received training and confidential information.

Additionally, the court noted that Lunsford operated as a technician of the former franchisee for more than two years in the Nashville area. The court also found that as the sole proprietor of Pro Touch Auto Services, Lunsford was providing precisely the same services as when he was an owner and technician of the former franchisee. Based on the court's finding that Lunsford breached the franchise agreement, the court enjoined both Lunsford and the nonsignatory Pro Touch Auto Services, citing case law giving the court authority to enjoin not only Lunsford but "servants or agents and those acting in collusion or combination with him."[15]

Use of Multiple Transfers

Sometimes, franchisees go to great lengths to create obstacles to enforcement of post-termination noncompete agreements. A recent case in Nebraska represents one franchisee's elaborate efforts to use multiple transfers to attempt to avoid enforcement. In *ServiceMaster Residential/Commercial Services, LP v. Proctor,*[16] the corporate franchisee, DLK&P, was owned by Kenneth Proctor and his parents. Kenneth was the corporate secretary of DLK&P and the production manager for the business. His wife, Linda Proctor, had no day-to-day responsibility for the business. Nevertheless, Kenneth and Linda both signed personal guarantees in which they agreed to be individually bound to comply with the terms and conditions of the franchise agreement as though they signed the franchise agreement in their individual capacities. Several years later, ServiceMaster sought to terminate the franchise agreements for nonpayment of fees. Prior to the effective date of the termination, David Proctor, Kenneth's father, filed bankruptcy and dissolved the corporate franchisee, DLK&P. All of the assets of DLK&P became property of David Proctor's bankruptcy estate.

Kenneth sought to purchase from his father's bankruptcy estate all the business assets and property formerly owned by DLK&P. ServiceMaster informed Kenneth that he was bound by the terms of the noncompete agreement, and if he purchased the assets of the business with the intent of operating in competition with ServiceMaster, they would pursue action against him. Regardless, Kenneth purchased the business assets from the bankruptcy estate on March 20, 2001. Three days later, Kenneth's wife, Linda, filed articles of incorporation for Pro Clean, Inc., a Nebraska corporation with a registered office at the same location as the former DLK&P had its office. Linda was the sole director and officer of Pro Clean. On April 18, 2001, Kenneth assigned to his wife Linda all business assets and property formerly owned by DLK&P that he purchased from the bankruptcy estate. No money changed hands and no purchase price was established. Linda then assigned all the assets to Pro Clean.

If It Looks Like a Duck

Pro Clean operated the same business as the former DLK&P ServiceMaster franchise using the same phone numbers and business assets. Pro Clean also sent solicitation letters to former DLK&P customers. Kenneth became an employee of Pro Clean and operated the business on a daily basis. From the time Kenneth operated as the production manager for DLK&P to the time that he became an employee of Pro Clean, he continued to operate the business out of the same location with the same employees and same equipment, performing the same services and using the same phone number, on a daily basis. On these facts, the court enforced the noncompete agreement against Kenneth to protect the franchisor's goodwill, reputation, and business system. Because the court neglected to address enforcement against Linda and Pro Clean, the franchisor filed a motion for clarification to expand the scope of the injunction to include Linda and Pro Clean.

Notwithstanding the fact that Linda and Pro Clean were not parties to the litigation at the time of the injunction hearing and did not sign the franchise agreement, the court found that Rule 65(d) applies to persons who are not parties or signatories "if they act as one with an enjoined party. If this were not the case, a party could evade injunctive relief by acting through his or her straw men."[17] Given the husband and wife relationship and the wife's active participation in setting up the competitive corporation and funneling the franchisee's assets to it, the result in this case is not unexpected.

Common Officers and Phone Numbers

Common officers and phone numbers also convinced a court that it was appropriate to enforce a covenant not to compete against nonsignatories in a not-for-publication decision rendered in *ATC Health Care Services, Inc. v. Southwestern Staffing Services, Inc.*[18] ATC Health Care Services, Inc., franchised temporary personnel services to the health care community. On January 24, 1997, ATC entered into a ten-year franchise agreement with Southwestern Staffing Services, Inc. The franchise agreement was signed by William W. Crocker, Southwestern's president. The franchise agreement contained a covenant not to compete forbidding Southwestern from engaging in any competitive or similar business to a franchised ATC center during or within one year after the end of the franchise term. The contract also required Southwestern to stop using any ATC telephone listings upon termination of the franchise agreement.

After a royalty dispute, Southwestern notified ATC in June 2000 that it was terminating the franchise agreement and that it sold ATC's telephone numbers. Subsequently, however, ATC learned that Crocker was serving as president of Arizona Home and Health Care (AHH), which was engaged in a competing business at the same office with the same telephone number. ATC sued Southwestern, Crocker, and AHH. In its complaint, ATC claimed that all of the defendants breached the covenant not to compete by retaining the telephone number, among other allegations. The defendants moved to dismiss on the basis that Crocker should not be liable for the corporate affairs of either Southwestern or AHH and that AHH should not be liable for the corporate affairs of Southwestern, whether or not Southwestern had breached the franchise agreement.

Taking ATC's allegations as true for purposes of analyzing the defendants' motion to dismiss, the court had little difficulty denying the motion.[19] The court characterized ATC's allegations as alleging that Crocker "personally supervised and carried out the alleged acts of wrongdoing with little regard for the corporate forms of either Southwestern or AHH."[20] The court found that those allegations alone were "enough to raise questions about whether [Crocker] should be held liable, especially in the interest of achieving an equitable result."[21]

The court also found that ATC's allegations against AHH were sufficient to impose liability, namely, that "Southwestern and AHH function as the same entity, shared resources (including telephone numbers and office space) and had the same corporate principal, namely Mr. Crocker."[22] The court also recognized that given the overall nature of ATC's allegations, it might be necessary to hold AHH liable in order to achieve an equitable result.[23]

Elaborate Ruse Fails

Perhaps the most elaborate ruse to avoid a covenant not to compete is illustrated in *Medicine Shoppe International, Inc. v. S.B.S. Pill Dr., Inc., Savannah B. Swartout.*[24] However, not even a bankruptcy of the corporate franchisee was sufficient to cloak this conspiracy. This case also illustrates that these disputes do not just happen in the post-term context, but also while the franchise agreement is in effect. In this case, Medicine Shoppe International, Inc., sued S.B.S. Pill Dr. and Savannah B. Swartout to enforce the terms of a franchise agreement previously entered into between Medicine Shoppe and nonparty Cape Fear Apothecaries, Inc. Swartout's father entered into a franchise agreement with Medicine Shoppe on June 9, 1976. Soon thereafter, he assigned the franchise to Cape Fear. Cape Fear operated the pharmacy on his property for twenty years, and Cape Fear renewed the franchise for a ten-year term beginning March 20, 1996. After obtaining her pharmacy license in 1996, Swartout became the pharmacist-manager of the Medicine Shoppe pharmacy. She acquired her father's stock in Cape Fear in 1998 and acquired sole ownership of the underlying real property in 1999.

Thinly Veiled Alter Ego

Once again, a royalty dispute culminated in a competitive dispute. In May 2002, Medicine Shoppe notified Cape Fear that it had underreported revenues and owed about $300,000 in unpaid fees. Swartout reacted to this news by incorporating Pill Dr., acquiring new permits, purchasing new inventory, repackaging and separating Cape Fear inventory, removing Cape Fear's office equipment and furnishings, and purchasing new office equipment and furnishings. Pill Dr. then began operating a pharmacy on the Swartout property under the name Hope Mills Drug.

Swartout then sent patients a prescription transfer authorization form that, among other things, stated thus: "Due to unforeseen circumstances, this pharmacy will no longer be run as a Medicine Shoppe. We are changing our name to Hope Mills Drug. You may expect the same care and treatment from our same staff. Only the name has changed to protect the innocent."[25]

Medicine Shoppe sued Cape Fear and obtained a temporary restraining order enjoining it and its agents and employees from operating or identifying the pharmacy on the Swartout property as anything other than a Medicine Shoppe. One day before a scheduled preliminary injunction was to be held, Cape Fear filed a Chapter 7 bankruptcy petition. After Cape Fear's bankruptcy filing, Swartout and Pill Dr. continued to operate the pharmacy under the Hope Mills Drug name and used the same telephone number.

Pill Dr. and Swartout argued that since neither one of them signed a franchise agreement with Medicine Shoppe, they should not be prevented from continuing to operate. Medicine Shoppe countered, arguing that Pill Dr. and Swartout were merely alter egos and successors to Cape Fear.[26] The court found that Pill Dr. did not have to acquire all of the assets of Cape Fear in order to treat Pill Dr. as Cape Fear's successor. It simply had to acquire the primary assets of the business, which the court found to include the location, the phone number, and the customer base.[27] Although ordinarily notice of a transfer to employees or customers is evidence negating a successor liability, the court focused on "the way in which the notice was given: 'only the name has changed. . . .'"[28] Therefore, despite a bankruptcy filing, the acquisition of new operating assets and the formation of a new corporation were not enough to prevent Swartout and Pill Dr. from an injunction forbidding them from violating the covenant not to compete signed by Cape Fear.

According to the court, Hope Mills Drug had the same customer base and the same employees and Swartout continued to be the pharmacist-manager, just as she was when the store was a Medicine Shoppe pharmacy. Swartout was also the president and sole owner of Cape Fear and became the president and sole owner of Pill Dr. Pill Dr. paid Cape Fear's final month of operating expenses, although it did leave Cape Fear's inventory of drugs and fixtures in the storeroom for the bankruptcy trustee.[29] But Pill Dr. acquired Cape Fear's customer lists and files without paying for them.[30] After reviewing testimony, the court found that a pharmacy's primary assets are its inventory, its customers and patient files, and its location. Using the same phone number, employees, and pharmacist-manager, little had changed. The court especially noted that Pill Dr. had represented to customers that only its name had changed.[31] Under these facts, the court had little trouble determining that Pill Dr. and Swartout were the alter ego of, or successor-in-interest to, Cape Fear.

Enforcement Is Thrown a Monkey Wrench

In *Grease Monkey International, Inc., v. Ralco Lubrication Services, Inc.,*[32] the franchisee, Ralco, was a corporation wholly owned by its sole officer and shareholder, Robert Lieberman. When Ralco signed the franchise agreement, Lieberman specifically stated that he was unwilling to become personally liable and specifically formed Ralco for the purpose of becoming the franchisee. Notwithstanding, Lieberman signed a personal guarantee in his individual capacity guaranteeing the franchisee's performance under the terms of the franchise agreement. The ten-year term of the franchise agreement expired on July 18, 1998. Two days later, Ralco sold all of its assets and inventory to Roadrunner Lube and Go, LLC, a Massachusetts limited liability company, the sole members of which were Lieberman's wife and mother-in-law. Lieberman had no ownership interest in Roadrunner but was employed by Roadrunner as the manager of Roadrunner's new operation at a salary of $400 per week. Roadrunner changed the signage on the building and removed all of Grease Monkey's trademarks, signs, logos, operating manuals, and marketing materials.

Grease Monkey sought a preliminary injunction precluding Lieberman, Ralco, and Roadrunner from continuing to operate a fast-service automotive lubrication business at the former Grease Monkey location. First, it argued that the covenant not to compete applied to Ralco, the corporation, and Lieberman, individually. Second, Grease Monkey argued that because Roadrunner was created to circumvent the noncompetition agreement, it was the alter ego of both Lieberman and Ralco. Lieberman responded by arguing that he was not bound by the terms of the franchise agreement because he did not sign it in his individual capacity. He also contended that although Ralco may be subject to the noncompete agreement, Ralco was not operating the Roadrunner business.

The court denied Grease Monkey's motion for preliminary injunction. Based on the language of the franchise agreement, it held that the post-expiration covenant not to compete only applied to the conduct of the franchisee and not that of the franchisee's officers, directors, or shareholders. The court found that it was uncertain whether Lieberman was individually bound by the terms of the agreement and "because Grease Monkey drafted the agreement, any ambiguity must be construed against it."[33] The court also held that although Lieberman signed a personal guaranty, it did not specifically include the noncompete agreement in the franchise agreement, and "he never entered into a separate noncompete agreement." Although this holding may seem incongruous, the court noted that subsequent versions of Grease Monkey's franchise agreement specified that guarantors are bound by the noncompete agreement, whereas the agreement signed by Lieberman did not. With respect to the alter ego argument, the court summarily dismissed that theory because it was unclear whether Lieberman was personally obligated by the noncompete agreement.

Two practical lessons come from the *Grease Monkey* decision. First, the language in personal guarantee agreements should obligate the individual to perform all of the obligations of the corporate franchisee, including post-term noncompete obligations. Second, without establishing a breach by Ralco or Lieberman, the court was loath to take action against Roadrunner or the individuals who operated the competitive business. Here, Grease Monkey was unable to establish that Ralco was operating Road Runner or that Lieberman was individually bound by the terms of the noncompete agreement. Without establishing a breach by Ralco or Lieberman, it is very difficult to argue that Lieberman's wife, mother-in-law, or Roadrunner assisted, aided and abetted, or facilitated a nonbreach.[34]

Sale of Business and Noncompetes

Covenants not to compete are relatively common in other business contexts, such as in employment agreements and sale-of-business agreements. Because of the unique nature of the employment relationship, employment cases on this topic are numerous, but not entirely relevant.[35] However, several courts have held that the franchise relationship is similar to the sale of a business in terms of the analysis of a covenant not to compete.[36]

For that reason, a survey of sale-of-business cases where the buyer sought to enforce a covenant not to compete against nonsignatories reveals very similar patterns to the franchise cases discussed above. Specifically, in situations where the buyer can demonstrate a breach by the seller and assistance, complicity, or conspiracy with a third party who happens to be a family member, injunctive relief often follows. These cases also show that key enforcement features illustrated in the franchise cases, i.e., operation at the very same location and with the same telephone number, are not indispensable elements.

In *Dad's Properties, Inc. v. Lucas,*[37] the plaintiff purchased a nightclub from Lucas Enterprises, jointly owned by Albert Lucas and his wife, Susan. The sale of the business included goodwill, stock, and all other furniture and fixtures. The sale agreement included a noncompete agreement for five years within fifty miles of the nightclub. About one year later, Susan Lucas formed a new corporation and began operating another nightclub within the fifty-mile radius. When threatened with litigation, Albert Lucas and Lucas Enterprises claimed that they had no connection with the new nightclub, which was owned by Susan and her new corporate entity.

The court looked beyond the corporate fictions established by Mr. and Mrs. Lucas and found that they intentionally violated the covenant not to compete by setting up a new corporate entity. The court found that "individuals and entities may be enjoined from aiding and abetting a covenantor in violating a covenant not to compete" and that an injunction not only binds the party who signed the contract, but also "those identified with them in interest, in privity with them, represented by them or subject to their control."[38] The court found that Susan and her controlled corporation aided and abetted Albert and Lucas Enterprises in violation of the covenant. Because of their close relationship to Albert, Susan and her new corporate entity were subject to the injunction enforcing the noncompete agreement.

In *Suburban Oil Service, Inc. v. Parker,*[39] Parker sold his fuel oil delivery business to Suburban Oil and agreed to a seven-year noncompete agreement. Parker continued working for Suburban Oil as an employee for two and a half years, after which he quit. Less than a week later, his wife began a new fuel oil delivery business known as Parker Oil Sales. The court found that "the law is adamant" that where a husband agrees to a covenant after the sale of a business, "a wife should not be allowed to obtain the benefits of the proceeds of said covenant and then defiantly, in her name, establish a like business. This recalls the old adage 'you can't have your cake and eat it too.'"[40]

Another example is the case of *Sulmonetti v. Hayes.*[41] In *Sulmonetti,* Frank Hayes sold a fuel oil business to Sulmonetti and agreed to a ten-year noncompete agreement. Shortly thereafter, Frank and his wife, Emily Hayes, organized a competing business with Emily as the sole stockholder, president, and treasurer. Emily sent fliers to all of the customers of her husband's former business and published an advertisement in the local business newspaper announcing the opening of the competitive business. Emily also used the customer list from her husband's former company and sought to take away as many customers as possible.

Sulmonetti brought an action to enforce the noncompete agreement against Emily and Frank, even though Emily did not sign the sale contract. The court concluded that "Frank and his wife, acting in concert, had contrived to deprive the buyer of the fruits of his purchase for their own advantage."[42] Although Emily did not sign the covenant not to compete, the court found that she "deliberately and willfully connived with her husband, and purposefully acted both with him and independently of him, to appropriate to herself and her husband the goodwill that the buyer had purchased from Frank."[43] Citing the "fundamental concept of fair dealing," the court found that Emily's conduct "amounts to a total disregard of that concept and reaches a form of unfair competition which calls for injunctive relief."[44]

Finally, in *West Shore Restaurant Corp. v. Turk,*[45] West Shore purchased a restaurant in St. Petersburg, Florida, from Irving Turk and a corporation owned by him. As part of the consideration for the sale, Turk agreed that neither he nor any of the stockholders of the corporation would become involved in the retail sale of food for a period of five years within seven miles of the former restaurant location. Shortly thereafter, Turk's father and a business associate formed a new corporation and bought two restaurants within the seven-mile radius. West Shore alleged that the entire arrangement was a subterfuge designed to evade the effect of the restrictive covenant.

The court found that Turk owned and operated both competing restaurants, supervised the operation of the restaurants, and violated the terms of the noncompete agreement through his father and the new corporation. In addition, the court held that Turk's father and business associate should be enjoined from aiding and abetting Turk in violation of his covenant even though they did not sign the original covenant not to compete.[46]

Common Themes

As these cases reveal, there are common themes in franchise and sale-of-business cases that will influence a court's willingness to enjoin the actions and activities of nonsignatories. Although courts use different language to express the concept, it always involves a desire to prevent nonsignatories from conspiring with, facilitating, aiding, or abetting a signatory to breach the covenant not to compete. In addition, courts generally desire to protect the fruits of the contract, whether that is the franchisor's goodwill and business system or the goodwill purchased by the buyer of an ongoing business.

A franchisor has a good chance of enjoining the unfair competition of not only its former franchisees, but also its "officers, agents, servants, employees, and attorneys, and upon those persons in active concert or participation with them"[47] if the franchisor can

(1) establish that the former franchisee has breached the noncompetition provisions of the franchise agreement;

(2) establish that the entity or individual operating the competitive business conspired with, acted in concert with, or aided and abetted the former franchisee in breaching the agreement; and

(3) demonstrate a familial or close relationship between the former franchisee and the operators of the competitive business.[48]

Other factors that tend to influence the courts are (1) the conspirator's own communications with customers indicating that nothing has really changed, (2) transfers of assets with no consideration among the conspirators, and (3) common management.

Drafting for Enforcement

As the cases indicate, the primary objective for including noncompete clauses in franchise agreements is to protect the franchisor's confidential information, trade secrets, and goodwill after the termination of the franchise agreement. Although the law will generally recognize the existence of a franchisor's goodwill based on ownership and use of registered trademarks through advertising and promotion, there is no reason why a franchisor should not include language in its franchise agreements specifically articulating the nature of its protectable goodwill interests and seeking acknowledgement by the franchisee of the protectability of these interests.

The franchise agreement should articulate the franchisor's investment of time and resources in the development and promotion of the franchisor's trademarks and business system.

The contract should also acknowledge that it would take a substantial amount of time, capital, and human resources to develop a similar system. Consequently, the franchisee should acknowledge that the franchisor would not enter into the agreement with the franchisee or provide the franchisee with any information regarding its business system, operational know-how, or confidential information unless the franchisee agreed to comply with the terms of the franchise agreement, including post-termination obligations.

If a franchise system involves repeat sales to an established customer base, the franchisor should gather information about the customers and dictate in the franchise agreement that such customer information belongs to the franchisor. Although this concept may not work for quick-serve restaurants or certain retail concepts, repeat-service businesses often gather customer information for purposes of marketing and billing. This factor was significant in both the *ATC* and *Medicine Shoppe* cases. To the extent that the franchise agreement mandates that this customer information belongs to the franchisor, any attempt by the franchisee to sell, transfer, or exploit the customer information after termination would represent a significant breach of the franchise agreement relating directly to the franchisor's goodwill. Such a breach would put the franchisor in a better position to enjoin not only the former franchisee, but also any individual or entity who would seek to exploit the customer information obtained from the former franchisee.

Almost all franchise agreements are of limited duration. At the termination or expiration of the franchise agreement, any right to use the franchisor's trademarks or business system comes to an end. Under established trademark law, any goodwill developed by the franchisee under the franchisor's trademarks inures to the benefit of the franchisor, not the franchisee or the franchisee's location.[49] This notion of limited rights is often at odds with the expectations of franchisees, who believe that they are entitled to sell or otherwise exploit any goodwill developed by them at the end of the franchise relationship. In reality, the franchise agreement is more like a lease.

At the end of the term, the lessee must return the property and has nothing to sell or continue using. A similar notion should be reinforced in the franchise agreement in those provisions addressing trademark rights and post-termination obligations. Although franchise salespeople may not like language in the franchise agreement articulating that the franchisee has nothing to sell at the end of the term, it would eliminate false expectations and facilitate successful post-termination enforcement.

The noncompete covenant itself should reinforce the fact that it is required in order to protect the franchisor's goodwill, business system, confidential information, and any specialized training or procedures made available to the franchisee. In addition, the covenant should specifically state that it applies to the franchisee; all personal guarantors; and all partners, officers, directors, shareholders, members, principals, or other individuals of franchisee entities.

Likewise, any separate personal guarantee should specifically state that it binds the personal guarantor to all post-termination obligations, including the covenant not to compete. The covenant should state that the franchisor is entitled to injunctive relief to enforce the terms of the covenant and that the injunctive relief extends to personal guarantors and the other individuals listed above. Finally, the covenant not to compete should incorporate the language of Rule 65 of the Federal Rules of Civil Procedure by stating that the court has the power to enjoin not only the franchisee, but also their officers, agents, servants, employees, and all others in active concert or participation with them. Not only would this give the franchisee and any personal guarantors notice that they are within the scope of the covenant not to compete, it would provide the court with additional

Practice Pointer

Draft Franchise Agreements to Avoid Future Problems

To keep the franchisee's second cousin from setting up shop after the contract expires, franchisors should require prospective franchisees to acknowledge in writing the franchisor's investment in developing and promoting the system. They should also acknowledge that:

- **The franchisor would not divulge system information without assurance that the franchisee agrees to comply with all contract provisions, including post-termination obligations.**
- **All customer information belongs to the franchisor.**
- **All goodwill accrues to the franchisor.**
- **All property, trademarks, and other confidential information belongs to the franchisor and must be returned at the end of the contract.**

Finally, the noncompete covenant should include the language of Rule 65 of the Federal Rules of Civil Procedure that the court has the power to enjoin the franchisee and its officers, agents, servants, employees, and all others in active concert or participation with the franchisee.

authority to grant injunctive relief against nonsignatories within the scope of the quoted language.

Familial and Close Relationships

In those situations where the franchisee is an individual, the franchisor must make a decision about whether it is going to require a spouse's signature on the franchise agreement, regardless of whether he/she will be involved in the business. As the cases set forth above indicate, it is not uncommon for individual franchisees to attempt to evade post-termination noncompete obligations by operating a competitive business by or through a spouse. This issue can be eliminated by requiring both spouses' signatures on the franchise agreement.

Alternatively, in those situations where a spouse is hesitant to be responsible for the financial obligations of the franchise business, the franchisor should request that the spouse sign a limited personal guarantee of all nonmonetary obligations, including post-termination obligations. The franchisor should also require other family members who will be involved in the business to sign similar limited personal guarantees.

In many instances, the involvement of family members is not known at the initiation of the franchise relationship. Indeed, family involvement may not happen until many years after the contract is signed. In the *Medicine Shoppe* case, more than twenty years and one renewal transpired before the daughter joined the business. However, family members often receive training from the franchisor when they are brought into the franchise business. Prior to and as a condition of providing the training and access to the franchisor's confidential information and business system, franchisors should demand the execution of a confidentiality and noncompetition agreement from family members.

The scope of nonsignatories should not be limited to family members, but could include managers, employees, or any other individuals exposed to the franchisor's business system and confidential information. If training is controlled by the franchisor, such would be an appropriate time to demand a signature on a confidentiality and noncompetition agreement.

Technicality Versus Reality

Although it may be true that a franchisor cannot technically enforce the terms of a written noncompete agreement against nonsignatories, the franchisor can seek to enjoin nonsignatories from conspiring with or aiding and abetting the franchisee in breaching the covenant. With sufficient factual evidence of cooperative conduct between the franchisee and the nonsignatories, courts will enjoin conduct that is damaging to the franchisor's goodwill and amounts to unfair competition. As the cases indicate, courts are more likely to scrutinize transactions between family members because they involve close relationships where cooperative conduct is easier to hide. On the other hand, in those situations where the nonsignatories acquired assets from the franchisee in what appears to be an arm's-length transaction, the courts are less likely to find that the former franchisee is in breach and that the nonsignatories aided and abetted any such nonbreach. By modifying the language of the franchise agreement and being more diligent in obtaining signatures from family members, franchisors can minimize the incidents of post-termination intrafamily transactions intended to evade the terms of a noncompete agreement.

Endnote

1. Covenants Against Competition in Franchise Agreements xv (Peter J. Klarfeld ed., 2d ed. 2003).
2. *See generally* Robert W. Emerson, *Franchising Covenants Against Competition,* 80 Iowa L. Rev. 1049 (1995).
3. 17A Am. Jur. 2d *Contracts* § 412 (2004).
4. McCart v. H & R Block, Inc., 470 N.E.2d 756, 761 (Ind. Ct. App. 1984).
5. *Id*. at 756.
6. *Id*. at 759.
7. *Id*. at 764.
8. *Id*. at 762.
9 .H&R Block Tax Serv., Inc. v. Sheets, 2006 U.S. Dist. LEXIS 8437 (E.D. Ky. 2006).
10. *Id.*at *6-8.
11. 937 P.2d 907 (Colo. Ct. App. 1997).
12. *Id*. at 912.
13. *Id*.
14. 981 F. Supp. 1079 (N.D. Tenn. 1997).
15. *Id*. at 1082 (citing Rigas v. Livingston, 70 N.E. 107 (N.Y. 1904)).
16. Bus. Franchise Guide (CCH) ¶ 12,251 (D. Neb. 2002).
17. *Id.*
18. Bus. Franchise Guide (CCH) ¶ 12,400 (E.D.N.Y. 2001) (not for publication).
19. *Id.* at 35,904.
20. *Id.*
21. *Id.*
22. *Id.*
23. *Id.*
24. 336 F.3d 801 (E.D. Mo. 2003).
25. *Id.* at 801.
26. *Id.* at 801.
27. *Id.* at 803.
28. *Id.* at 803–04.
29. *Id.* at 802.
30. *Id.*
31. *Id.* at 805.
32. 24 F. Supp. 2d 120 (D. Mass. 1998).
33. *Id*. at 124.
34. *See also* ATC Health Care v. Nurses Staffing, Bus. Franchise Guide ¶ 11,825 (E.D.N.Y. 2000) (franchisee officer not individually bound by the terms of the franchise agreement, including noncompetition provisions, because he did not sign the franchise agreement in his individual capacity).
35. Norlaund v. Faust, 675 N.E.2d 1142, 1155 (Ind. Ct. App. 1997) (ophthalmologist's noncompete agreement in employment contract enforced against his wife and her eye-care business where there was evidence that wife, through her business, was acting in concert with husband to assist him in breaching noncompetition agreement); Kasco Serv. Corp. v. Benson, 831 P.2d 86 (Utah 1992) (court indicated a willingness to enjoin former employee's wife and competing business but for the passage of time that rendered prospective injunction of little or no value to employer); Las Vegas Novelty, Inc. v. Fernandez, 787 P.2d 772 (Nev. 1990) (former employee and his newly formed corporation would be enjoined for violating the noncompete agreement if employer could prove that the corporation breached the covenant not to compete in active concert with former employee and with knowledge of the covenant); Ingredient Tech. Corp. v. Nay, 532 F. Supp. 627 (E.D.N.Y. 1982) (former salesman's wife and salesman's son were enjoined to prevent unfair competition against salesman's former employer); Schnuck's Twenty-Five, Inc. v. Bettendorf, 595 S.W.2d 279 (Mo. Ct. App. 1979) (corporation of former employee enjoined from violating employee's noncompete agreement because corporate defendant was acting directly or indirectly in concert with, and by and under the control and direction of the former employee); Chem. Fireproofing Corp. v. Bronska, 542 S.W.2d 74 (Mo. Ct. App. 1976) (wife of former employee and her corporation enjoined from violating the employee's noncompete agreement where there was evidence that the wife and corporation conspired to violate the noncom-

pete agreement and aided and assisted the employee in violating his contract); Orkin Exterminating Co., Inc. v. Hendrick, 267 N.E.2d 352 (Ill. App. Ct. 1971) (wife of former employee enjoined where she knowingly participated and aided in the evasion and violation of the restrictive covenant); Mills v. Murray, 472 S.W.2d 6 (Mo. Ct. App. 1971) (in addition to actual and punitive damages, corporation formed by former employees was enjoined where there was evidence that it conspired to violate the terms of the noncompete).

36. Sentilles v. Kwik-Kopy Corp., 652 So. 2d 79, 83 (La. Ct. App. 1995) (a franchise is much more akin to the sale of a business, and the franchisee's agreement not to compete is part of the compensation for the franchisor's transfer of its reputation and know-how); Jiffy Lube Int'l, Inc. v. Weiss Bros., Inc, 834 F. Supp. 683, 691 (D.N.J. 1993) (covenants not to compete in franchise agreements are closer to agreements ancillary to the sale of a business).

37. 545 So. 2d 926 (Fla. Dist. Ct. App. 1989).

38. *Id.* at 928–29.

39. 63 Pa. D. & C. 2d 91 (Luzerne County, Pa. 1973).

40. *Id.* at 92.

41. 198 N.E.2d 297 (Mass. 1964).

42. *Id.* at 394–95.

43. *Id.* at 396.

44. *Id.*

45. 101 So. 2d 123 (Fla. 1958).

46. *Id.* at 129.

47. FED. R. CIV. P. 65(d); ServiceMaster/Residential Commercial Serv., LP v. Proctor, Bus. Franchise Guide ¶ 12, 252 (D. Neb. 2002); Las Vegas Novelty, Inc. v. Fernandez, 787 P.2d 772, 774 (1990); *see also* Day Cos. v. Patat, 440 F.2d 1343, 1345 (5th Cir. 1971) (the court enjoined strangers to a sale-of-business contract, finding that they were "knowingly . . . in complicity with [the seller] in violation of the contract not to compete").

48. *But see* Pirtek USA LLC v. Zaetz, No. 3:05-CV-1002 (AVC), 2005 U.S. Dist. LEXIS 38908 (D. Conn. Dec. 14, 2005) (although former franchisee breached covenant not to compete for a two-month period of time by assisting his son in establishing a competing business, the court denied the injunction because franchisor could not establish irreparable harm in that there was no "continuing harm" once former franchisee ceased providing assistance).

49. Pappan Enter. v. Hardies Food Sys., 143 F. 3d 800 (3d Cir. 1998).