LJN's FRANCHISING BUSINESS & LAW ALERT®

Non-Compete Cases: Does Anyone Really Win?

May 2010
By Charles S. Modell and James M. Susag

Many articles have been written about the enforcement of non-compete agreements in franchise cases. The "textbook" law is clear, and we address that law in this article. However, the message that we in the franchise bar have been sending our clients about the law may not be so clear: Nobody really "wins" these cases — except the lawyers who take them to court.

Most franchise agreements include two types of covenants not to compete. First, there is an "in-term" covenant that prevents the franchisee from competing with himself and with the system during the term of the franchise agreement. Most franchisors also have a "post-term" covenant that prohibits competition within a certain area (which always includes the location of the former franchised unit) for a period of time following termination or expiration of the franchise agreement.

Textbook Law

California has had a law on its books for years that prohibits enforcement of post-term non-competition agreements, but does not address in-term covenants. Other states have more general restrictions on restraints on competition that are often cited in an effort to defeat enforcement of non-compete clauses. The courts have interpreted the laws of most states, however, as permitting covenants not to compete, both in-term and post-term, to the extent they reasonably protect the interests of the franchisor or the franchise system.

In Georgia, in *Atlanta Bread Co. v. Lupton Smith*, 2008 WL 2264863 (Ga App, 2008), a case addressed in previous issues of this newsletter, the Georgia Supreme Court set a bar for reasonableness that will be difficult for any franchisor to overcome. However, in the reported cases from other states, courts have found numerous justifications for enforcement of non-compete provisions that expire within a year or two following termination or expiration of a franchise agreement and do not extend geographically beyond the trade areas of the former franchisee or other franchisees in the system. They have found that enforcement of such covenants is necessary "to protect and maintain [the franchisor's] trademark, trade name and goodwill," to keep a franchisee from converting customers from the franchise brand to an independent brand, "to protect against loss of control of reputation, loss of goodwill and consumer confusion," and to decrease the likelihood that other franchisees will "flaunt their agreement just as [the franchisee] has done." This does not mean, however, that franchisors always "win" these cases. Most of the reported decisions on covenants not to compete are issued in response to a motion brought by the franchisor seeking to have a court issue a restraining order, shutting down the franchisee's business before any trial on the merits. No court will act precipitously in that situation. In fact, most federal courts require the trial court to consider the four "Dataphase" factors before issuing an injunction: 1) the probability that the franchisor will succeed on the merits of its claim; 2) the threat of irreparable harm to the franchisor if the requested relief is denied; 3) the balance between the harm to the franchisor if injunctive relief is denied and the injury that will result to the franchisee if the relief is granted; and 4) the public interest. *Dataphase Sys, Inc. v. C. L. Sys., Inc.*

What Happens in the Real World?

There are numerous reported cases every year in which courts find in favor of the franchisor on all four factors and issue the injunction. In those cases, with the franchisee out of business, one can only imagine the conversation between the franchisee and her attorney, particularly if the lawyer was consulted before the franchisee made the decision to terminate or not renew the franchise agreement, or to not cure a breach that ultimately resulted in

termination. Not only has the franchisee lost her business, but she will likely also have a large legal bill from her attorney and, possibly, be liable for the attorneys' fees of the prevailing franchisor if the franchise agreement contained a clause awarding attorneys' fees to the franchisor or the prevailing party.

Even in these cases, however, what has the franchisor won? If the franchisor is successful in obtaining the injunction, and the franchisee closes its business, the franchisor can tell its franchisees it prevailed, but it has still lost the revenues from the former franchisee's royalties. Moreover, when a franchisee or former franchisee must close her business, it is likely that a bankruptcy proceeding is in the franchisee's future, and the franchisor will be unlikely to recover any judgment for damages or attorneys' fees.

Making matters worse for franchisors, it is not easy for a franchisor to prove all four of the elements necessary to obtain an injunction. Certainly, there are more than a handful of cases where the franchisor did not obtain the injunction it sought. In those cases, franchisee counsel might celebrate their victories, but the franchisee may ultimately find the spoils of victory to be worse than defeat. Defeating a motion for an injunction does not mean that the covenant not to compete is not enforceable!

When a court fails to issue an injunction, it is usually because the court finds that under the specific facts presented to it, either the franchisor has not shown irreparable harm, or that the ultimate harm to the franchisor by not issuing the injunction is less than the harm caused by putting the franchisee out of business. This does not mean, however, that the covenant is not enforceable. In most of the reported cases, the court has found in favor of the franchisor on the issue that will ultimately be decided, mainly that the franchisor is likely to succeed at trial on the merits of its claim. In those circumstances, the franchisee continues in business only long enough to suffer through extensive discovery, a lengthy trial, and another six-figure legal bill. At the end of the day, if the court confirms at trial its initial view that the franchisor will prevail on the merits, then the franchisee will also be liable for a significant damage award for breach of the covenant and possibly still suffer a permanent injunction enforcing the covenant in the future.

The Legal Advice We Give to Our Clients

Unfortunately, we as attorneys do not always report to our clients the practical effects of these court decisions. The seed for this article was planted by a prominent franchisee attorney who wrote an article on the franchisor-bashing Web site, BlueMauMau.com, reporting on a recent case, *Anytime Fitness, Inc. v. Family Fitness of Royal, LLC*, 2010 WL 145259. The writer reported that the franchisor's covenant was not enforced. The writer did explain that any precedential impact of that case was based on the unique factual circumstances of the case. (In fact, the same federal district court issued an injunction enforcing this same franchisor's post-term non-compete agreement just 16 months earlier. *Anytime Fitness, Inc. v. Reserve Holdings, LLC*.)

What was not reported on BlueMauMau.com is that in the *Family Fitness* case, the federal district court actually held in favor of the franchisor on what it termed the "most significant" of the *Dataphase* factors, "the likelihood that the movant will prevail on the merits." In considering two fitness facilities that existed within six miles of each other, the court ruled that "Anytime Fitness is likely to succeed on the merits." Thus, the *Family Fitness* case probably sets a better precedent for franchisors than it does for franchisees, and merely delays the ultimate enforcement of the covenant. Of course, any "victory" that either party might claim is a hollow one, as they continue to run up legal fees.

So what should we be advising our clients? Attorneys who assist franchisors in writing these clauses should first ask their clients whether they really need a non-compete provision in order to protect the goodwill of the system. Most hotel franchise systems deal with experienced hotel owners and do not have post-term covenants not to compete. Indeed, not every system will suffer significant harm if a franchisee opens an independent business following termination of the franchise, even in competition with other franchisees. The majority of franchisors will likely still feel, however, that they would be irreparably harmed by competition from a franchisee either during or following the term of their franchise agreement. In those situations, non-compete provisions are both appropriate and necessary, but they should be written so as to balance the protection needed for the system with the burden imposed on the franchisee, thus resulting in a clause that provides necessary protection without overreaching.

Attorneys who represent franchisors who are faced with a franchisee violating a covenant should be counseling their clients as to the cost of enforcing the non-compete provision and the uncertainty of getting an early resolution of these cases through injunction. Obtaining an injunction is not always easy and will rest on the specific facts of the case. While franchisors generally do ultimately win these cases, either at the injunction stage or at trial, a long,

drawn-out trial comes at great cost, both in terms of the legal fees and the time devoted to the matter. Nevertheless, for many franchisors, it is only by seeing these cases to the end that they will send the message to franchisees that they cannot convert the goodwill of the franchise system for their own benefit, and they cannot take what they learned from the franchisor and use it to establish a competing business.

The message that franchisee lawyers should be giving their clients is an even more difficult one. If the franchisee believes he can outlast the franchisor and win a war of attrition, then there may be merit in challenging covenants not to compete. If the franchisee's goal is to stay in business a year or two longer, and the profits from those couple years will be far greater than the legal fees that will be spent in a losing effort, then it also might make sense for that franchisee to challenge the covenant (though the franchisee should also take into account the damages and franchisor attorneys' fees for which he might be liable).

On the other hand, if the goal of the franchisee is to stay in business, then he is far better off finding a way to work with his franchisor than challenging a covenant not to compete, because, ultimately, absent a state statute rendering covenants not to compete unenforceable, the franchisor does usually win these cases. If that happens early in the process, the franchisee will be most disappointed, though it may be a blessing in disguise, because if it happens at the end of a long trial, only the lawyers will come out ahead.

Charles S. Modell and **James M. Susag** are shareholders in Larkin Hoffman Daly & Lindgren Ltd. in Minneapolis. Mr. Modell can be contacted at cmodell@larkinhoffman.com, and Mr. Susag can be contacted at jsusag@larkinhoffman.com.