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FRANCHISE RELATIONSHIP

Post-Expiration Covenants Not to Compete: Grant Limited 'Free Agency' to Franchisees

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Advocates of "fair franchising" have focused on a wide variety of issues in recent years, as is evident from the breadth of issues addressed in the Small Business Franchising Act of 1999 (the Coble Bill). While some provisions of the Coble Bill are quite controversial and may have limited its likelihood of passage, other provisions address discrete issues that should be addressed—with or without legislation. Perhaps the most significant issue of this nature is the enforceabil-ity of post-expiration covenants not to compete.

Legal Enforceability

A significant amount of commentary has focused on the circumstances in which a franchisor can obtain an injunction to enforce a post-termination covenant against competition. Generally speaking, to enforce a covenant not to compete, a franchisor must prove that the covenant is ancillary to an otherwise lawful franchise contract, and that it is (a) necessary to protect the franchisor, (b) not injurious to the public interest, and (c) reasonable in time, subject matter and territory. See Robert W. Emerson, "Franchising Covenants Against Competition," 80 Iowa L. Rev. 1049, 1054 (1995) (Emerson). While most of the reported cases concern whether the time, subject matter and territorial scope of the covenant are reasonable, the most fundamental issue with such covenants is whether they are reasonably necessary to the protection of legitimate business interests of the franchisor. *Id.* at 1067-81. In general, the bases on which franchisors seek to enforce covenants not to compete are to prevent the franchisee from misappropriating the franchisor's (1) trademarks and/or trade dress; (2) confidential intellectual property, including trade secrets and other methods conveyed through training; and (3) good will and customer contacts developed through the franchise relationship. *Id.*

As explained by Mr. Emerson, the misappropriation of valid intellectual property can be addressed through statutory actions under the Lanham Act and the Uniform Trade Secrets Act, and, therefore, enforcement of a broad covenant not to compete is generally not necessary to protect the first two interests. (There is essentially no dispute that a former franchisee should cease use of the franchisor's trademarks, trade dress and trade secrets, although the extent of efforts required to cease the use of such intellectual properties can be a subject of significant disagreement.) The third "legitimate interest" cited by franchisors, namely their good will in the franchised business, is the most questionable, since such local good will is generally developed through the efforts and expenditures of the franchise owner. Nevertheless, courts have generally used all three rationales in enforcing post-termination covenants not to compete via injunction—despite the availability of other, less dramatic remedies to protect the franchisor's interests.

While enjoining any former franchisee from continuing to engage in his chosen field of business is a harsh remedy that is often difficult to justify, enforcement of a covenant not to compete on *expiration* of a franchise agreement can be particularly harsh and unfair. This article explains the arguments against the enforcement of post-expiration covenants, why such covenants are harmful to franchising as a method of business expansion, and why the franchising community should adopt a compromise that will provide an equitable solution to the quandary posed by post-expiration covenants not to compete.

Franchisee Is 'Locked in' During The Franchise Agreement Term

While the FTC Rule and the current system of mandatory presale disclosure, along with proper due diligence, can enable a prospective franchisee (or prospect) to learn much about the pros and cons of a franchise system, such presale investigation is an imperfect process. Furthermore, problems with a franchise system's management may only develop during the term of the franchise agreement.

Franchisees faced with a franchisor who has failed to administer the system in a manner according with the franchisee's reasonable expectations may wish to abandon the franchise system, either to operate their business as an independent entity or to join a competing franchise system. However, in the majority of states, to unilaterally terminate the franchise agreement during its term and to avoid the noncompete, the franchisee must prove either fraud in the inducement of the franchise agreement or breaches by the franchisor of such magnitude as to frustrate the essential purpose that the franchisee had for executing the fran-

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chise agreement.

Proving a material breach by the franchisor can be highly difficult, because franchise agreements are generally written in such a manner as to leave the responsibilities of the franchisor extremely vague and discretionary. Sometimes, the only clear obligations of the franchisor are negative—to permit the franchisee to use the trademarks, trade dress and operations manual to operate the franchised business, and (perhaps) to refrain from placing another franchise within a specific proximity of the franchisee. By contrast, the typical franchise agreement contains few terms that obligate the franchisor to provide any of the services generally associated with a franchise relationship—training and operational support, enforcement of system standards, new product development and mobilization of group buying power, use of advertising funds to promote the operating units, and appropriate efforts at system expansion (the performance obligations). See, e.g., Peter C. Lagarias, "Uniform-ity in California Franchise Agree-ments," 21 Franchise L.J. 136 (2002).

Given such realities, during the term of the franchise agreement most franchisees have little choice but to complain to the franchisor concerning their execution of the performance obligations and to try to operate their franchise to the best of their ability. While collective action by an independent franchisee association may be of some assistance in addressing performance deficiencies, unilateral withdrawal from the franchise is generally not a viable option during the term of the franchise agreement.

Franchisor Has More Control Over the Relationship

A franchisor also generally has limited rights to terminate a franchise agreement, absent a franchisee's failure to pay mandatory fees or a franchisee's breach of its material obligations in operating the business (such that the franchisee's conduct is likely to cause harm to the brand). Furthermore, most franchise systems provide some form of protected territory for each franchise—which means that, absent a franchisee's material breach, the franchisor is "stuck" with the franchisee as its exclusive operator in that territory for the term of the agreement.

While this reality would seem to even the playing field between the parties, it is important to recall that the franchisor has tremendous continuing control over defining the performance obligations that a franchisee must meet. Through both the franchise agreement and the operations manual (which is nearly always incorporated by reference into the terms of the franchise agreement), the franchisor can mandate both qualitative and quantitative levels of performance. Furthermore, the franchisor controls the method and timing of qualitative inspections of the franchise, and the franchisor's employees have tremendous discretion in grading a franchisee's performance. In short, there are numerous ways in which a franchisor can ensure that a franchisee does not "underperform," and, if it does, to terminate that franchise.

The Time for Renewal: The Status of the Parties

Renewal rights are an important aspect of a franchise agreement for a prospect, because most prospects view their purchase of a franchise as a long-term equity investment in the franchised brand. Absent a right to renew the franchise at the expiration of the current agreement, the security of the franchisee's investment is in doubt, thereby arguably limiting the value of the franchise opportunity. Therefore, a large percentage of franchise agreements in most industries provide the franchisee with what is essentially an option to renew the relationship at the end of the contract's term. In such cases, unless the franchisee is in breach of its material obligations when the renewal period occurs (typically between 12 months and six months before expiration), he or she will have the right to continue the franchise relationship.

A franchisor might therefore argue that, because it provided a unilateral renewal option at the outset of the relationship, the franchisee should likewise be bound to either continue with the franchisor at expiration or get out of that type of business altogether. Such an argument, however, ignores the parties' respective positions at expiration. The franchisee is the party that has made the substantial financial and personal commitment to the franchised business and generally has assumed the risk of failure personally. Furthermore, the good will in the franchised business is largely developed through the franchisee's local operations, as well as through national advertising campaigns—which are, to a significant degree, typically funded through contributions from the operating units (whether franchised or company-owned). Given the franchisee's investment in the brand, a franchisee could do tremendous harm to his business by seeking to walk away from the brand at expiration. Franchisees in well-run systems would logically seek to renew and then, if they wished to "cash out" and avoid the day-to-day responsibility of franchise ownership, simply sell the ongoing business to a new franchisee.

On the other hand, a typical franchisor has much less to lose if a franchisee chooses to walk away at the end of a franchise term. The franchisee, assuming it has performed adequately, has enabled the franchisor to develop local good will in its trademarks. While such good will may be particularly tied to a specific geographic location, if the franchisor has properly used the advertising contributions to increase public recognition and acceptance of the system's trademarks, the good will in the community generated through existing operating units should be highly transferable to new units located elsewhere in the franchisee's community. Furthermore, if the franchisor forces the former fran-

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chisee to cease use of (and any reference to) the franchise system's trademarks, trade dress and trade secrets (and to change its operations sufficiently to eliminate aspects distinctive to the franchise), the former franchisee will be limited in his ability to trade on good will attributable to the former franchise.

In *most cases*, the only reason that a franchisee would decline to renew its franchise relationship is significant dissatisfaction with the franchise system. This dissatisfaction can be caused by one or more types of problems, which can be characterized as follows: (1) problems with the franchisor's performance in the recent past, (2) concerns about the franchisor's future intentions with regard to performance of its obligations to the brand, and/or (3) unreasonable terms and conditions in the franchise agreement offered at renewal.

The franchisee may have legitimate concerns with a franchisor's execution of its performance responsibilities (as discussed above), as well as (1) competition by the franchisor through alternative channels of product distri-bution, or (2) the franchisor's acquisition of competing brands or acquisition of the franchisor by a multibrand operator. Each of these problems is such that a breach-of-contract action (even brought by a group of franchisees) might be of minimal value, since damages may be difficult to prove and may not be enough in any event to deter the franchisor from future breaches of its obligations. Furthermore, some of the issues may not amount to a breach of contract at all, but may constitute circumstances in which the franchisee reasonably finds that renewal of the franchise is not a reasonable business decision.

Furthermore, a franchisee's renewal option is generally limited by several contingencies, the most significant of which is the requirement that the franchisee sign the franchisor's "then-current form of franchise agreement." As franchise systems mature, franchisors often incorporate more onerous and one-sided terms into their standard agreements. Such changes may involve higher royalties or other fees, significant additional capital investments by the franchisee, an elimination or decrease in the franchisee's exclusive territorial rights, an alteration of language that decreases the franchisor's performance responsibilities, and/or changes in dispute resolution clauses to favor the franchisor.

Franchisors argue that their "then-current franchise agreement" cannot be too onerous, since it must withstand "the test of the marketplace" for selling franchises. This argument has two significant fallacies: (1) A mature franchise system is not terribly concerned with selling new franchises, but rather with milking as much profit as possible from its existing franchise system, and (2) a veteran franchisee, with its intimate knowledge of the system, has much greater sensitivity to the significance of contract terms than a prospect and is not in the same "market" as the prospect. Therefore, it is not evident that the "franchise marketplace" forces franchisors to offer franchise agreements that are "reasonable" from the perspective of existing franchise owners.

Blindly Permitting Enforcement Of Post-Expiration Covenants

If a covenant not to compete is enforceable after expiration, the franchisee may be forced to "knuckle under" and accept the renewal offer—regardless of the franchisor's problems or the unduly onerous terms of the new franchise agreement. After all, the franchisee may be tied to long-term leases that it has an obligation to honor, and it will not be able to do so unless it either remains in business or finds someone to assume its obligations. Furthermore, even if it can get out of the lease, the franchisee may have few marketable skills to use outside of the type of business franchised—thereby severely limiting his options if it would choose to walk away at expiration and be forced to honor a post-expiration noncompete. Therefore, in such circumstances, a franchisee will typically have little choice but to renew under such unfavorable circumstances and perhaps then seek a buyer of its franchise—a buyer with whom it may be less than candid with regard to the nature of the franchise relationship.

Furthermore, in the long run, if such post-expiration covenants not to compete are enforceable, regardless of franchisor conduct, their existence may scare qualified prospects away from pursuing franchise opportunities. After all, why would well-qualified people agree to be perpetually bound to a franchise system if they can open independent businesses and have the right to use their skills in another manner if that business doesn't work out? It stands to reason that covenants not to compete that are perpetually enforceable (even after expiration) are a substantial deterrent against purchasing a franchise and are not beneficial to the long-term vitality of franchise networks.

What Franchisors Should Offer

The Coble Bill's flat ban on post-expiration covenants not to compete makes sense from a certain perspective—after all, restraints on competition are generally disfavored (both in law and in American culture), and covenants not to compete can be used as a hammer to force franchisees to accept unfair renewal terms. However, a flat ban also would have the likely unintended consequence of leading franchisors to cease offering renewal options in franchise agreements, thereby removing what is often a valuable right for a franchise owner. After all, from the franchisor's perspective, franchisees should not be given renewal rights at the outset of the relationship unless they are similarly bound by post-expiration obligations.

On the other hand, given the overwhelming power of franchisors in shaping and altering the franchised business and their relationships with franchisees, some measure of protection is needed to assure fair treatment of franchisees at the expiration of the franchise agreement. The American Association of Franchisees and Dealers has proposed that franchisors voluntarily agree to the following: "Upon expiration of a franchise agreement, where the franchisee is not in default and where no reasonable right of renewal is afforded a franchisee, the franchisee should not be subject to any covenant not to compete unless supported by separate, new and adequate consideration." This sounds sensible, but what do these provisions mean?

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A Reasonable Right of Renewal

A reasonable right of renewal obviously varies with the circumstances, but it should satisfy certain basic criteria, such as:

- The nonfinancial terms of the renewal agreement are reasonably consistent with prior terms, except where legal developments have mandated changes to the terms;
- The royalty is justifiable in terms of the franchisor's need for adequate revenue to fulfill its performance obligations and to make a fair profit, and should not unduly burden the franchisee from earning a reasonable return on its business' operations;
- Other new financial obligations are justifiable: for example, renovation requirements should not be imposed unless company-owned units have experienced demonstrable benefits from such renovations;
- The franchisor has a track record of competent execution of its performance duties; and
- The franchisor provides reasonable assurances of continued competent performance, based on employment of qualified management personnel to lead the franchised system.

Requiring franchisors to offer their franchisees reasonable renewal rights will encourage franchisors to shape their franchise agreements through consultation with existing franchisees and to continually communicate with the franchisees concerning system administration. While such a course of conduct will not conclusively prove that the franchisor offered a reasonable right of renewal (since the offer may not be reasonable to the franchisee at issue), it would provide persuasive evidence that the system is being run in a manner reasonable to most franchisees.

Assuming a reasonable renewal option is provided, a franchisee would appear to have no legitimate reason to seek to abandon the franchise system and operate a comparable business—either independently or as a franchisee for a competitor. In such circumstances, a franchisor should be able to enforce a post-expiration covenant not to compete, provided that its scope is otherwise valid under the applicable state law.

New, Separate and Independent Consideration for a Noncompete

A franchisee who does not receive a reasonable right of renewal has, in a sense, had its franchise terminated. In such circumstances, the franchisee should not be forced to exit from its chosen business completely, unless the franchisor pays it "separate, new and adequate consideration" to honor a post-expiration covenant not to compete. This follows from the commonsense principle, "If you want to put me out of business, buy me out!" After all, the franchisor that does not offer a reasonable right of renewal probably still wants to do business in the franchised territory—either through refranchising or through the opening of company-owned units that could trade on the brand's existing good will in the market. At a minimum, it is reasonable to require the franchisor to pay for protection from competition by its former franchisee, since such compensation would provide the former franchisee with the time to plan and pursue a different career or business venture.

The obvious challenge with this requirement is determining "adequate consideration" for such a post-expiration noncompete. If the franchised business is profitable and situated in a location with good future prospects, the franchisor presumably would be interested in buying the franchised business. However, in any event the franchisor should be required to provide consideration roughly equaling the business' going concern value, less any value that the franchisee can obtain through selling the business' physical assets or (if feasible) resuming the business outside the restricted area. "Adequate consideration" will be tougher to determine if the franchise has struggled or if it is located in a declining neighborhood. The franchisor would probably argue that it should have to pay only the franchisee's projected earnings during the restricted period; the franchisee would likely argue that problems with the franchise system depressed its profits and that it should receive consideration for the local good will in the brand.

While valuation disputes will occur, franchisors and franchisees should be able to compromise on such issues, assuming that no other outstanding issues stand in the way.

The American Association of Franchisees and Dealers' proposal with regard to post-expiration covenants not to compete is reasonable and balanced. Franchisees should not be forced to either renew an unreasonable (or unprofitable) franchise relationship or leave their chosen vocation, absent new, separate and adequate consideration for refraining from lawful business activities. This proposal also permits franchisors to pursue their business objectives, provided that they give reasonable compensation to affected franchisees.

Franchisors should adopt the AAFD's position in their franchise agreements and condition enforcement of a covenant not to compete *post-expiration* on the provision of a reasonable right to renew the franchise relationship *or* new, separate and adequate consideration. If a significant number of franchisors will not do so, franchisees should pursue passage of federal legislation specifically mandating that courts not enforce post-expiration covenants not to compete unless the franchisor has provided a reasonable right to renew the relationship.

In the meantime, franchisees faced with the prospect of being forced to sign an unfair renewal agreement or closing their business should consider bringing their cases to court—before expiration of the original agreement. A franchisor that does not provide a reasonable right of renewal does not act in good faith, and in such circumstances courts may be reluctant to enjoin a former franchisee from engaging in lawful post-expiration competition.

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