Noncompetition Covenants: Protecting the Interests of Franchisees

Almost every franchisee, at one time or another during the life of the franchise agreement, has asked the questions: "Why am I paying these royalty fees? It's my business, I'm here slugging it out every day, what is the franchisor doing for me?"

Are these legitimate questions? You bet. Do franchisors have a good response? You bet.

By Gretchen L. Jankowski and John R. Previs

As we are all aware, in today's world, intellectual property has great value. One need only hear the words Coca-Cola, Nike or McDonald's to know instantly the concepts of market leadership, longevity and identification of products that those words convey.

All franchise systems strive to achieve the same kind of brand identity and spend a great deal of money doing so. And, having built the brand, the franchisor must act to preserve its integrity. Thus, a major part of the value delivered by the franchisor for the franchisee's royalty fees is the brand identity and integrity.

Franchisees enter the system because they want to be associated with "the real thing" and not some imitation. The trademarks, service marks and trade dress are the principal elements of the brand identity that must be established and protected.

In today's world, intellectual property has great value.

The Heart of Brand Integrity

A more legitimate question a franchisee may ask is: "Why am I paying for the brand identity and integrity when former franchisees are still in business and using the brand without paying for it?" This question goes to the heart of brand integrity. Each franchisee has the right to expect the franchisor to police enforcement of the use of the brand so that only franchisees who are paying for the brand are able to use it.

Franchise fees and royalty fees are used by a franchisor for a variety of purposes that benefit the franchisees such as training programs, support services, intranets, product-service innovation, store design improvements and protecting brand identity and integrity. The franchisor has a great self-interest in preserving its rights to these intellectual property assets because they are an important part of the franchise offering. Likewise, the franchisor has a duty to franchisees who are paying for the brand not to allow former franchisees to use the brand without paying for it. Few franchisees appreciate the fact that the noncompetition provisions found in franchise agreements are really for their benefit.

Royalty fees are spent, in part, by the franchisor in paying for the costs of establishing and enforcing its rights to the brand for the benefit of itself and the paying members of the franchise network.

But what exactly is the brand? In a broad sense, the brand consists of trademarks, service marks and trade dress; confidential information, trade secrets and know-how; and an exclusive and limited group of users.

Noncompetition covenants are designed to cover each of the elements of the brand. However, increasingly the validity of the noncompetition covenants is being questioned by the courts and the legislatures. California, Georgia and South Dakota are states in which enforceability of noncompetition covenants can be questioned.

Validity and Enforceability

More recently, the Supreme Judicial Court of Massachusetts in the case of Boulanger v. Dunkin' Donuts Inc. requested amicus curiae briefs in the enforceability of noncompetition covenants ancillary to a franchise agreement. The International Franchise Association filed a brief that captures the essence of the brand with the following assertion:

"The validity and enforceability of these

(Continued on page 22)

(Continued from page 21)

[noncompetition] covenants is also vital to protect the interest of IFA's franchisee members, who have invested substantial amounts in their businesses and rely upon these covenants to protect the trade secrets and intellectual property for which they pay franchise fees and royalties, and on the basis of which they invest substantial amounts of money in the capitalization of their businesses."

When a franchisee becomes a former franchisee, the disassociation and de-identification element of the brand is easiest to enforce. Trademarks, service marks and trade dress are protected by federal and state laws and there are few, if any, defenses to infringement actions. Particularly, disassociation and de-identification, the former franchisee is no longer part of the exclusive and limited group of users of the externally visible elements of the brand.

But, what about the confidential information, trade secrets and know-how learned during the time as a franchisee? Of course, the manuals can be returned. However, there is no way to download the data stored in the former franchisee's memory bank. In its brief, the IFA cited the trial court's holding on this point:

"Here the plaintiff, a longtime employee in the Dunkin' Donuts system, entered into the three franchise agreements with his eyes wide open. He was represented by counsel. He has acquired a substantial amount of information that is confidential propriety. He profited from his relationship with Dunkin' Donuts. Should plaintiff join a competitor within two years of the termination of his franchises, it is unlikely that he could set aside and not use that information to benefit himself or his employer to the detriment of Dunkin' Donuts and other franchisees within the 5-mile radius who, as parties to identical restrictions, have a right to expect Dunkin' Donuts equitably to enforce the restrictions.

Reasonable Limitations

How is it possible to prevent the use of the franchisor's proprietary information by a former franchisee? The simple answer is to cause the former franchisee not to conduct or be involved in the same business. Although our principles of free enterprise impose limitations on a blanket prohibition, our legal system allows reasonable limitations on the ability to compete using the franchise system's proprietary information. Unless this enforcement takes place, former franchisees can use, free of charge, the same property for which the actual franchisees are paying. A franchisor cannot afford to let former franchisees "have it your way." As to enforcement of noncompetition covenants, a franchisor must "just do it" to protect itself and its franchisees.

> Few franchisees appreciate the fact that the noncompetition provisions found in franchise agreements are really for their benefit.

This element of fairness to the other franchisees who are playing by the rules is often overlooked by franchisors in arguing for court enforcement of noncompetition covenants. Too often franchisors focus on the harm caused to them as owners of the brand without focusing on the interests of their royalty-paying franchisees.

As only royalty-paying franchisees are entitled to use this brand-specific intellectual property to the exclusion of all others, noncompetition covenants protect the interests of franchisees in good standing. So, "where's the beef" about paying royalty fees? Instead, franchisees should say "I'm lovin' it" to noncompetition covenants. ■

Gretchen L. Jankowski and John R. Previs are shareholders of the Pittsburgh-based law firm Buchanan Ingersoll. Janokowski can be reached at 412-562-1417 or jankowskigl@bipc.com and Previs at 412-562-8957 or previsjr@bipc.com.