Reasonableness and the Enforceability of Franchise Non-Competition Covenants

BY MIKE MELVIN AND ALEX WARSHICK

Most franchise agreements contain non-competition covenants ("non-competes"). These covenants prohibit the franchisee and anyone else who signed the franchise agreement (and possibly others) from engaging in certain business activities that are competitive with the franchisor (and its other franchisees) for a defined period of time within a defined geographic area. Often, a very broad non-compete will apply during the term of the franchise agreement and a more limited one will apply upon termination or expiration.

A Contract in Restraint of Trade

The legitimate purpose of these clauses is to prevent current and former franchisees from unfairly competing against the franchisor and other franchisees using "inside" knowledge of the franchisor's business. However, while non-competes seek to address legitimate franchisor concerns, the effect of these clauses is to restrain the persons subject to them from engaging in certain types of trade. This puts non-competes in conflict with a historical and deeply rooted principle of the common law, that contracts in restraint of trade are unenforceable.

In order to overcome this presumption of unenforceability, a franchisor must demonstrate that its non-compete is reasonable in scope.[1] This article provides a brief overview of the factors a court will take into consideration in deciding whether or not a franchisor's non-compete is reasonable.

The Applicable Standard of "Reasonableness"

As a preliminary matter, franchisors should be aware that, in determining whether a non-compete in a franchise agreement is reasonable, a court is likely to hold the non-compete to a stricter standard than it would if it was examining a non-compete in another type of commercial agreement. While the courts have not established a special rule for enforcing non-competes in franchise agreements, they have drawn a stark distinction between non-competes found in agreements for the sale of a business and those found in employment contracts, with which franchise agreements share a number of similarities.[2]

Courts have generally been more willing to enforce non-competes in agreements for the sale of a business because, in the sale of a business, the purchaser typically makes a payment to purchase the goodwill of the business. In this context, a non-compete given by the seller is simply a means of assuring the purchaser that, having received a payment in exchange for the goodwill, the vendor will not "steal" it back by operating a competing business.

However, there is no payment to purchase goodwill upon the termination of an employment agreement. Moreover, employees are typically at an economic disadvantage in any litigation over a non-compete and are subject to a general imbalance of power relative to the employer throughout the relationship. For these reasons, courts subject non-competes in employment agreements to much greater scrutiny.[3]

Several courts, in examining non-competes in franchise and franchise-like agreements, have applied the stricter "employment agreement" standard, citing, among other things, the imbalance of power between the franchisor and franchisee.[4] Given these precedents, and given the imbalance of power that exists between franchisor and franchisee, which is analogous to the imbalance of power in employment relationships, franchisors and their counsel should assume, at least for the purposes of drafting these clauses, that their non-competes will be rigorously tested using the "employment agreement" standard.

The "Reasonableness" Test

Assuming the application of the "employment agreement" standard, the test set out by the Supreme Court of Canada in *J.G. Collins Insurance Agencies Ltd. v. Elsley*, [1978] 2 S.C.R. 916 will be applicable. The test can be summarized as follows:

[1] *KRG Insurance Brokers (Western) Inc. v. Shafron*, 2009 SCC 6 at para. 17 ("*Shafron*").
[2] *Shafron, supra* at paras. 21.
[3] *Shafron, supra* at paras. 22-23.
[4] See, for example, *Allegra of North America and Allegra Corporation of Canada v. Russell Sugimura*, (August 26, 2008), Milton, CV-08-21790-00 (Ont. S.C.) ("*Sugimura*") at para. 16; and *Wm. Tapper Ltd. v. Valero Energy Inc.*, 2017 NLTD(G) 63 at paras. 73-76.

1. Does the franchisor have a proprietary interest entitled to protection?
2. Are the temporal and spacial features of the clause too broad?
3. Is the clause unenforceable as being against competition generally?

A Protectable Interest

Generally, a franchisor will have a proprietary interest that is entitled to protection with respect to trade secrets and similar confidential and proprietary information, including knowledge of the franchisor's customers.[5] However, franchisors create potential enforceability problems for themselves when they require franchisees to sign non-competes that seek only to protect the franchisor from competition. A non-compete will not be considered reasonable, and therefore will not be considered enforceable, where its purpose is merely to lessen competition for the franchisor.[6]

Some case law suggests that it may be difficult for franchisors to establish the existence of a protectable interest if they are engaged in common types of business, such as the operation of a drug store or a pizza restaurant, in which general industry know-how is more important to the business than the trade secrets or proprietary methods of the franchisor.[7] It has also been held that where the franchisor has no intention of re-establishing its business within the geographic area of the non-compete, it will not have a protectable interest.[8]

In light of the above, franchisors are advised to consult with their legal counsel to ensure that their non-competes are tailored as much as possible to protectable interests and not merely to limiting competition.

Temporal and Spacial Limits

The scope of a non-compete must be no wider than is reasonably required in order to adequately protect the franchisor's protectable interests.[9] If it is too long or covers too wide an area, it will be found to be unreasonable.

The period of a non-compete, unless it is clearly excessive, will usually not be the determinative factor in a dispute over enforceability. Courts appear to accept a period up to two years in many cases, depending, of course, on the facts of each particular case.[10] Non-competes that restrict the franchisee for longer periods of time will require justification, such as the business being of a highly specialized nature.[11]

Where non-competition clauses are found to be unenforceable due to scope, it is often the geographic scope that is the issue. While, in some circumstances, it may be possible to enforce non-competition obligations in an area broader than the actual territory in which the franchisor's business operates[12] (particularly if the non-compete is otherwise very narrowly framed), this will not normally be the case. The Supreme Court of Canada has stated, as a general proposition, that "[a] non-competition clause that applies outside the territory in which the business operates is contrary to public order."[13] Accordingly, courts will want to see the non-competition area limited to the actual market territory of the franchise in question and possibly those of other franchises and/or corporate locations in the franchisor's system. Franchisee's should work with their counsel to ensure that appropriate geographic limitations are incorporated into the franchisor's non-competes.

Ambiguity

Finally, franchisors should note that non-competes must be drafted in very clear language. If the terms of a non-compete are ambiguous, then it will be impossible to prove that the scope of the non-compete is reasonable and therefore that it can be enforced.[14] In the leading case on the question of ambiguity, the non-compete in question defined its geographic scope as the "Metropolitan City of Vancouver." However, the phrase "Metropolitan City of Vancouver" had no clear meaning and the Supreme Court of Canada refused to enforce the clause.[15] The Supreme Court also stated that courts should not use the doctrines of "notional severance" or "blue pencil severance" (techniques by which the Courts may sometimes, in effect, "rewrite" a clause to make it enforceable) to "fix" otherwise unenforceable non-competes.[16]

Conclusion

While non-competes provide important protections for franchisors, these protections may prove illusory unless the non-compete clauses have been carefully drafted by knowledgeable counsel to be reasonable, i.e., to extend no further than is necessary to protect the franchisor's legitimate interests. It is a good idea for franchisors to revisit their non-compete clauses with their counsel, from time to time, to ensure that these clauses can be relied upon when the time comes to restrain the activities of a current or former franchisee.

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[5] *J.G. Collins Insurance Agencies Ltd. v. Elsley*, [1978] 2 S.C.R. 916 ("*Elsley*") at paras. 21-22, citing *Herbert Morris Ltd. v. Saxelby*, [1916] 1 A.C. 688 (H.L.)
[6] Maguire v. Northland Drug Co., [1934] S.C.R. 412 at para. 12-13.
[7] See *Maguire, supra*, note 6 and *Pizza Pizza Ltd. v Gatto*, [1996] OJ No 4087 at paras. 25-26.
[8] *Sugimura, supra*, at paras. 18-22; *MEDIchair LP v. DME Medequip Inc.*, 2016 ONCA 168 at paras. 51-52.
[9] *Elsley, supra*, at para. 25; See also *Greening Industries v Penny*, 1963 CarswellNS 37, 49 M.P.R. 219 (NSSC) at para 23 and *Cheshire, Fifoot & Furmston's Law of Contract*, 13th ed, (London: Butterworths, 1996) at page 420.
[10] See Jennifer Dolman et al., "Restrictive Covenants in Franchise Agreements," *Advocates' Quarterly* 43 (2014) at page 452.
[11] See the Supreme Court decision *Guay Inc. c Payette*, 2013 SCC 45 ("*Payette*").
[12] *Imvescor Restaurants Inc. v. 3574423 Canada Inc.*, 2011 ONSC 1609 at paras. 91-92; aff'd 2012 ONCA 387.
[13] *Payette, supra*, at para. 65.
[14] *Shafron, supra*, at para. 43.
[15] *Shafron, supra*, at paras. 58-59.
[16] *Shafron, supra*, at para. 36.