


ARIZONA

by Christina M. Noyes*

1. **Has the state addressed covenants against competition in the context of franchising?**
 - ❓ **Does the state have a franchising statute or regulations that address covenants against competition?**
 - ❓ **Does the state have a covenants statute of general applicability that would encompass franchise covenants?**
 - ❓ **Have the courts addressed covenants in the context of franchising either under a statute or under the state's common law?**

Arizona does not have a franchising statute or regulations of general applicability addressing covenants against competition.

The Arizona Vehicle Dealer Requirements and Restrictions Act prohibits a manufacturer from coercing a new motor vehicle dealer not to participate in other lines of motor vehicle businesses “unless justified by reasonable business considerations.” Ariz. Rev. Stat. Ann. § 28-4458B. Any provision in a franchise or distributorship agreement waiving compliance with any provision in this Act is void except that a person is permitted to enter into an agreement waiving any such provision or voluntarily settling legitimate disputes if the franchisee or distributor “receives separate and valid consideration at the time” that the waiver is executed. Ariz. Rev. Stat. Ann. § 28-4458G. There are no reported cases under this section of the statute.

Arizona’s Uniform State Antitrust Act (USAA) prohibits unreasonable restraints of trade and can apply to covenants against competition if they are so restrictive that they are deemed unreasonable restraints on trade. Ariz. Rev. Stat. Ann. § 44-1402.

The USAA provides that “a contract . . . between two or more persons in restraint of . . . trade or commerce . . . is unlawful.” Although, on its face, the USAA appears to require that any contract that has the effect of restraining trade in any respect is illegal, Arizona courts have followed the lead of federal court decisions under the Sherman Act and held that only unreasonable restraints of trade are prohibited. *Three Phoenix*

* Christina M. Noyes is a member of the firm of Gust Rosenfeld, P.L.C. in Phoenix, Arizona. Ms. Noyes had research assistance on this chapter from Remy M. Halpern.

Co. v. Pace Industries, Inc., 135 Ariz. 113, 118–19, 659 P.2d 1258, 1263–64 (Ariz. 1983); *Tee Time Arrangers Inc. v. Visto Gold Partners, LLC*, 2008 WL 4149295, *11 (Ct. App. 2008) (decision by a group to participate in a new discount golf card program with an exclusive participation clause was not an unreasonable restraint of trade).

There are no reported cases deciding that a restrictive covenant in a franchise agreement violated the USAA. A few Arizona courts have applied the USAA to restrictive covenants in other contexts. In *Three Phoenix, supra*, the court held that restrictive covenants that divided the market between two competitors violated the antitrust law prohibiting horizontal market divisions. In that case, a company sold two of its divisions to two different buyers and procured a covenant not to compete from both as to the line of business that each buyer did not acquire. One buyer then sued the other to enforce the covenant. The court ruled that the covenants were unenforceable because they were not really ancillary to the sale of a business and were, therefore, subject to the per se rule against horizontal market division by competitors. In *Bonney v. Northern Arizona Amusement Co.*, 78 Ariz. 155, 277 P.2d 248 (Ariz. 1954), the court held that a covenant not to compete given by a former employee and minority shareholder upon the redemption of his stock was not an illegal restraint of trade. *Id.* at 159–60.

In Arizona, a limited number of cases have addressed a restrictive covenant in a franchise agreement. *Snelling & Snelling, Inc. v. Dupay Enterprises, Inc.*, 125 Ariz. 362, 364–65, 609 P.2d 1062 (Ct. App. 1980); *Furniture Medic, L.P. v. Jantzen*, Bus. Franchise Guide (CCH) ¶ 12,749, 37,511–12 (D. Ariz. 2003) (unpublished); *Miller v. Hehlen*, 209 Ariz. 462, 467–70, 104 P.3d 193 (Ct. App. 2005); *First Ascent Ventures, Inc. v. DLC Dermacare, LLC*, 2006 U.S. Dist. LEXIS 77945 (D. Ariz. 2006); *Fitness Together Franchise Corp. v. Higher Level Health and Fitness, Inc.*, 2009 WL 2753026, *2 (D. Ariz. 2009) (unpublished opinion). In the *Snelling* case, the court enforced one provision of a post-term restrictive covenant while striking down another. The covenant prohibited the former franchisee from operating a similar business within 35 miles of his former territory for three years after termination and within 35 miles of any other Snelling office or franchise area for 18 months following termination. *Snelling*, 609 P.2d at 1064–65. The *Furniture Medic* case imposed a two-year restrictive covenant against owning a furniture repair business after termination, but only for the county in which the franchisee operated. *Furniture Medic* at 37,511.

In the *Miller* case, the court held that a terminated H & R Block franchisee may not enforce a restrictive covenant against a former employee because she had executed the employment agreement with the description “doing business as H & R Block.” *Miller*, 104 P.3d at 198–201. In *Fitness Together*, the former franchisee failed to respond, and the court entered a permanent injunction for one year within eight miles of the franchise territory, but only for one-on-one personal fitness training, because that was how the franchisor described its business method in the complaint. *Fitness Together* at *2. In *First Ascent*, the court found that the restrictive covenant was reasonably limited in time and place where it prohibited any interest in a competitive business for three years after termination of the franchise agreement if located within the franchise areas or within 30 miles of a system location. However, the court refused to enforce the covenants because of the franchisor’s “unclean hands” and bad faith in dealings with the franchisee. *First Ascent* at *14–18.

While the court has not yet had the opportunity to address the case on the merits, in *Noodles Development, L.P. v. Latham Noodles, LLC, et al.*, 2009 WL 2710137, *3 (D.

Ariz. 2009), the court determined that a franchisor was permitted to seek emergency injunctive relief on the franchisee's trademark and trade dress infringement only to preserve the status quo until it had a substantive determination on the merits of its claim through arbitration. This was because the franchise agreement stated only that the franchisor "had the right" to petition for an temporary or permanent injunction on the franchisee's use of the marks, violation of the confidentiality, and covenants not to compete. The franchise agreement contained a mandatory arbitration clause but did not permit the franchisor to seek a permanent injunction before obtaining an arbitration determination. After the individual defendants failed to pay the arbitration fees, the court permitted the case to be heard outside of arbitration. *Noodles Development, LP v. Latham Noodles, LLC*, 2011 WL 204818, *2 (D. Ariz. 2011).

In the *In re Fralc* case, 2008 WL 1932311 (Bankr. D. Ariz. 2008), a bankruptcy court determined that a franchisee's discharge in bankruptcy did not result in the discharge of a pre-bankruptcy arbitration award enforcing the non-compete provision. PuroSystems terminated a franchise agreement for a franchise with a specific territory in and around Tucson, Arizona, and then filed for arbitration. The arbitration panel granted the franchisor monetary relief and also enjoined the franchisee from competing in the designated territory for a two-year period from the date of the arbitration award. The franchisee then filed bankruptcy. After the discharge, the franchisor sued in district court to enforce the nonmonetary provisions of the arbitration award. The franchisee claimed first that the discharge prevented the enforcement of the non-compete portion of the arbitration award and that the non-compete period must start from the date of termination, not from the date of the arbitration award. The bankruptcy court held that the district court had the ability to decide the non-compete issue as long as it did not impose discharged monetary obligations on the debtor. The court remanded the issue of the non-compete starting date to the district court, but no final decision has been reported. *Id.* at *2-5.

Under Arizona law, a covenant against competition will not be enforced if the restraint is greater in scope than necessary to protect the legitimate interests of the party seeking to enforce it, or if those interests are outweighed by hardship to the restricted party or public injury. The scope of a covenant is defined by its duration, geographic area, and the activity prohibited. There is no exact formula for weighing these three factors. In the context of employee covenants by physicians (and probably other professionals), the likely injury to patients and the public will almost always outweigh all of the other factors. *Valley Medical Specialists v. Farber*, 194 Ariz. 363, 367-73, 982 P.2d 1277, 1281-86 (Ariz. 1999) (en banc).

An early case decided under Arizona law, U-Haul attempted to enforce a post-termination non-compete agreement against a former U-Haul dealer. *In re Saban*, 30 B.R. 534 (B.A.P. 9th Cir. 1983). After U-Haul terminated the dealer's rental agency agreement, the dealer filed for bankruptcy. U-Haul sought to enforce the non-compete provision preventing the former dealer from engaging in a similar rental business within Maricopa County for the time period coterminous with an existing Yellow Pages telephone directory listing, plus one year. For reasons that were not fully explained, the court ruled that the covenant should be examined more carefully than those executed by sellers of businesses. Although the court found that the time period, geographic scope, and prohibited activities were reasonable, the court declined to enforce the non-compete agreement because it applied only upon termination of the contract for a

breach by the agent, which the court deemed unenforceable as a penalty against Arizona public policy. *Id.* at 540.

In a case of first impression, the district court for Arizona in *Compass Bank v. Hartley*, 430 F. Supp. 2d 973 (D. Ariz. 2006), specifically addressed a step-down provision as a permissible means to comply with the requirement that restrictive covenants be no broader than necessary to protect the employer's interest. The stock option agreement for a bank financial services employee had a non-solicitation, non-compete, and nondisclosure covenant stated as "2 years/18 mo./12 mo." as well as a geographical restriction from engaging in a competitive business within "50 miles (and if 50 miles is determined by the court to be overly broad, then 25 miles)". *Id.* at 977. The court determined that the two-year time period for a financial services employee was unreasonable, but a one-year time period was long enough for the new portfolio manager to gain the confidence of the bank's clients. The court also found a 25-mile limit to be a reasonable geographic scope. The court found that "under limited circumstances carefully crafted" step-down provisions are a permissible application of Arizona's blue-pencil law if the provisions permit a court to cross out some unreasonable sections in favor of more reasonable ones without rewriting them. *Id.* at 981.

2. Have the courts articulated the "legitimate interests" of the franchisor that will support enforcement of a covenant against competition contained in a franchise agreement?

❓ If so, what are they (e.g., protection of goodwill, protection of confidential information), and in what contexts did the issue arise?

❓ If not, what interests have been recognized in other contexts (e.g., employment agreements, the sale of business context)?

In *Snelling & Snelling, Inc. v. Dupay Enterprises, Inc.*, 125 Ariz. 362, 609 P.2d 1062 (Ct. App. 1980), the court did not expressly address whether franchise covenants should be treated similarly to sale-of-business cases or employment cases—or uniquely. The court looked to the standards enunciated in Arizona business sale cases as its primary guide for the enforceability of a restrictive covenant in the franchise context. *See Gann v. Morris*, 122 Ariz. 517, 519–20, 596 P.2d 43, 44–45 (Ct. App. 1979), and *Piercing Pagoda, Inc. v. Hoffner*, 465 Pa. 500, 508–13, 351 A.2d 207, 211–13 (Pa. 1976), a Pennsylvania case involving a restrictive covenant in a franchise agreement. (The Snelling franchise agreement provided that the contract was governed by Pennsylvania law, but the parties had agreed Arizona law would control.) The court held that a restrictive covenant in a franchise agreement against engaging in a similar business within 35 miles of the franchisee's former business was enforceable because it was reasonably necessary to protect the business interests (goodwill and customer contacts) of the franchisor. However, the court refused to enforce the restrictive covenant prohibiting competition within 35 miles of other Snelling franchise locations. That restriction was found overbroad because it was not limited to an area where the franchisee had established customer contacts and goodwill. *Snelling*, 609 P.2d at 1064–65.

In *Fitness Together Franchise Corp. v. Higher Level Health and Fitness, Inc.*, 2009 WL 2753026 (D. Ariz. 2009) (unpublished opinion), the court stated that a non-compete clause is unreasonable and unenforceable if it is broader than necessary to protect

the legitimate interests of the franchisor. After terminating the franchise agreement, the franchisor filed suit alleging that the former franchisees were continuing to offer “competitive personal fitness services,” utilizing the franchise system and proprietary assets. The court granted a preliminary injunction enforcing the one-year, eight-mile restriction. However, the court compared the restriction sought against how the franchisor described its business method in the complaint and limited the injunction to “one-on-one personal fitness training” instead of a broader restriction on competitive personal fitness services. The court also prohibited the former franchisee from any unauthorized use of the franchisor’s franchise system or proprietary assets and ordered the franchisee to return all confidential and proprietary information. *Id.* at *2.

In *First Ascent Ventures, Inc. v. DLC Dermacare, LLC*, 2006 U.S. Dist. LEXIS 77945 (D. Ariz. 2006), the district court for Arizona determined that Dermacare, an Arizona based franchisor of skin-care clinics, was barred from enforcing its post-termination non-compete because of its “unclean hands.” Dermacare had executed a franchise agreement and a master regional franchise agreement for Colorado clinic locations. The agreements prohibited the franchisees from owning, maintaining, or having an interest in a competitive business located in the franchisee’s designated area or within 30 miles of a Dermacare clinic for three years after the termination of either agreement. After operating for a year, the franchisees coordinated and attended a trade association meeting with other Dermacare franchisees. Dermacare’s principal disapproved of the meeting and the existence of an association without involvement by the franchisor. The principal then attempted to coerce the owners into signing highly restrictive amendments prohibiting the franchisees from contacting non-Colorado franchisees, threatened the franchisees with financial ruin if they fought back, refused to grant requests to use the local-area advertising fund monies paid by the franchisees, and cut off communications by the franchisor’s personnel to the franchisees. *Id.* at *14–18.

After the franchise contracts were either terminated or rescinded, the franchisees continued to operate two skin-care clinics under a different name, but in the same location with the same phone number and offering the same services. The court found that the non-compete provision was reasonable as to time and geographic territory, that the franchisees had breached the covenant, and that Dermacare had suffered irreparable harm and loss of goodwill. The court also found that the franchisor had suffered irreparable harm from the inability to establish a new franchisee in the former franchisee’s territory, the loss of actual and potential customer data, and intangible damage to the franchise system. The court stated that in order to obtain an injunction against the franchisees, Dermacare must have acted fairly and without fraud or deceit in the controversy at issue because an injunction is an equitable remedy. The court found that Dermacare acted in bad faith, and its unclean hands prohibited it from enjoining the former franchisees from operating competing clinics. However, the franchisor’s proprietary interest in its name, logos, marks, manuals, other confidential information, and its telephone numbers were deemed worthy of protection by the court, which issued an injunction preventing the former franchisees from using these assets. *Id.* On appeal, in an application for attorneys’ fees, the court found that neither party prevailed and that both parties should bear their own costs. The Ninth Circuit also determined that the district court did not abuse its discretion in its determination. *First Ascent Ventures Inc. v. DLC Dermacare, LLC*, 312 Fed. Appx. 60, *1 (9th Cir. Ariz. 2009).

The Arizona District Court in *Furniture Medic, L.P. v. Jantzen*, Bus. Franchise Guide (CCH) ¶ 12,749 (D. Ariz. 2003) (unpublished), found that a furniture repair franchisor would suffer irreparable harm to its established goodwill, name, and relationships with franchisees if the court did not enjoin the former franchisee from engaging in direct competition with Furniture Medic franchisees by continuing to operate a similar business under a different name in Maricopa County. The court noted that the failure to enforce the non-compete agreement could damage the franchise system if former franchisees could terminate their franchise agreements and “compete with impunity.” Citing a New Jersey case, the district court stated that while the harm to the former franchisee is substantial, the harm to the franchisor is greater. *Id.* at 37,512.

In *In re Fralc*, 2008 WL 1932311 (Bankr. D. Ariz. 2008), the bankruptcy court noted that the pre-petition arbitration award protected the franchisor’s name and right to the telephone number, and upheld the two year non-compete in the franchisee’s former protected territory in and around Tucson, Arizona. *Id.* at *2–5. In *In re Saban*, 30 B.R. 534, 539–41 (B.A.P. 9th Cir. 1983), the court held that enforcing the non-compete agreement against engaging in any rental business offering similar rental equipment was reasonably necessary to protect U-Haul’s business.

In *Miller v. Hehlen*, 209 Ariz. 462, 104 P.3d 193 (Ct. App. 2005), at issue was an employment agreement between the franchisee, “Margaret Miller doing business as H & R Block (‘the Company’)” and the employee, Hehlen. The employment agreement contained a noncompetition and non-solicitation clause that applied during the term of the employment agreement and for two years after termination. The agreement also provided that it inured to the benefit of the company and that the franchisor was intended to be a third-party beneficiary. H & R Block terminated Miller’s franchise, and Miller began operating a similar business under a different name. Hehlen left Miller’s employment and went to work for the franchisor at a different location. Hehlen contacted Miller’s customers with information he had retained from his prior employment with Miller and prepared a tax return for one of Miller’s former clients. In response, Miller sued Hehlen for violation of the employment agreement. The court determined that Miller’s ability to enforce the employment agreement was contingent on her continuing to do business as H & R Block. If she had wanted the noncompetition provision to apply to her personally, as opposed to her “doing business as H & R Block,” then Miller should have drafted the agreement accordingly. As a result, the court did not address any of the franchisor’s protectable interests in its decision. *Id.* at 198–201.

Arizona courts hold that in employment contracts, the employer has a legitimate interest in maintaining its customer information and relationships and is entitled to be protected against unfair competition. This interest must be balanced against the employee’s right to pursue his or her livelihood and the public need for the employee’s services. *Phoenix Orthopaedic Surgeons, Ltd. v. Peairs*, 164 Ariz. 54, 57, 790 P.2d 752, 755 (Ct. App. 1989); *Bryceland v. Northey*, 160 Ariz. 213, 216–17, 772 P.2d 36, 39–40 (Ct. App. 1989); *Amex Distributing Co. v. Mascari*, 150 Ariz. 510, 516, 724 P.2d 596, 602 (Ct. App. 1986) (customer information that is truly confidential and inaccessible to a substantial degree is given the measure of protection accorded to true trade secrets, but customer information is not proprietary, and its use is not unlawful where customers do business with more than one source and customer information is known to competitors. Employer’s protectable interest is limited to those customers to whom the former employee represented the employer’s goodwill. Close customer contact with the attendant

ability to divert customer's trade is strong justification for obtaining a covenant against competition from one through whom the goodwill of the business is developed and exercised.). A post-employment restriction is unreasonable and will not be enforced if (1) the restraint is greater than necessary to protect the employer's legitimate interest or (2) if the employer's legitimate interest is outweighed by the hardship to the employee. *Nouveau Riche Corp. v. Tree*, 2008 WL 5381513, *5 (D. Ariz. 2008).

Where the employee possesses no special skills or the employer's business is not unique, the courts refuse to enforce a restrictive covenant. *Truly Nolen Exterminating, Inc. v. Blackwell*, 125 Ariz. 481, 482, 610 P.2d 483, 484 (Ct. App. 1980); *Lessner Dental Laboratories, Inc. v. Kidney*, 16 Ct. App. 159, 161, 492 P.2d 39, 41 (Ct. App. 1971). An employer has no protectable interest after losing an account through no action taken by former employee. *Hilb, Rogal & Hamilton Co. v. McKinney*, 190 Ariz. 213, 216, 946 P.2d 464, 467 (Ct. App. 1997). Employers cannot enforce covenants against competition simply to eliminate competition or to prevent former employees from exercising the skill and general knowledge they acquire or increase through experience and instruction while employed. *Bryceland, supra*; *Lessner, supra*. The restrictions must be only for the time it takes for the customers to become comfortable with the new employee. *Compass Bank v. Hartley*, 430 F. Supp. 2d 973, 979–81 (D. Ariz. 2006) (protecting the bank's unspecified legitimate business interests in enforcing a noncompetition provision, non-solicitation provision, and prohibition on the use of any trade secrets, customer lists, or customer information against a financial services employee).

In the context of the sale of a business, the recognized interests of the buyer are protecting the goodwill of the business and preventing unfair competition. *Henderson v. Jacobs*, 73 Ariz. 195, 201–02, 239 P.2d 1082, 1086–87 (Ariz. 1952); *Gann v. Morris*, 122 Ariz. 517, 519, 596 P.2d 43, 45 (Ct. App. 1979). See also *Bonney v. Northern Arizona Amusement Co.*, 78 Ariz. 155, 159, 277 P.2d 248, 251 (Ariz. 1954) (the sale of a minority interest in a business, without a transfer of the goodwill of the business, is sufficient basis for a covenant against competition); *The Mastro Group, LLC v. American Restaurant Enterprises, Inc.*, 2008 WL 4017948, *3–5 (Ariz. Ct. App. 2008) (unpublished).

3. What time limitations have courts recognized as reasonable in the franchise context?

❓ If no franchise cases have been decided, what time limitations have been recognized in other contexts?

❓ How have they been related to the interests protected?

The reasonableness of time limitations in the franchise context has been addressed in three reported cases and one unpublished case. In *Snelling & Snelling, Inc. v. Dupay Enterprises, Inc.*, 125 Ariz. 362, 364–65, 609 P.2d 1062, 1065–65 (Ct. App. 1980), the court upheld a three-year restrictive covenant without discussing how the time period related to the franchisor's protectable interests in customer contacts and goodwill. The court in *Furniture Medic, L.P. v. Jantzen*, Bus. Franchise Guide (CCH) ¶ 12,749, 37,512 (D. Ariz. 2003) (unpublished), enjoined a former franchise from operating a competing business for two years but noted that the reasonableness of the time frame was never challenged by the franchisee. In *First Ascent Ventures, Inc. v. DLC Dermacare*,

LLC, 2006 U.S. Dist. LEXIS 77945, *14–18 (D. Ariz. 2006), a three-year noncompetition covenant for a related entity unit and master regional franchisee was deemed reasonable. In *Fitness Together Franchise Corp. v. Higher Level Health and Fitness, Inc.*, 2009 WL 2753026, *1–2 (D. Ariz. 2009) (unpublished opinion), the court enforced a one-year restrictive covenant against the former franchisee without any discussion regarding protectable interests. The court specified that the restriction started from the date of termination, without addressing the eight months from the date of termination to the date of the court’s decision in which the former franchisee was violating the non-compete agreement. In *In re Fralc*, 2008 WL 1932311, *2–5 (Bankr. D. Ariz. 2008), an arbitration decision enjoined the terminated franchisee from competing in the designated territory for a period of two years from the date of the award.

In *In re Saban*, 30 B.R. 534, 539–40 (B.A.P. 9th Cir. 1983), the court enforced a restrictive covenant for the duration of the agent’s existing telephone directory listing plus one year thereafter. (The covenant was ultimately held to be unenforceable because it applied only upon a termination of the contract for breach by the agent and was therefore unenforceable for public policy reasons as a penalty.)

In deciding whether employee covenants are enforceable, Arizona courts acknowledge that an employer has protectable interests where the goodwill of the business was developed by an employee who had close customer contacts and the attendant ability to divert customer trade. A “reasonable” time is therefore limited to the period necessary to obtain and train a replacement and provide an opportunity for the replacement to demonstrate his effectiveness to customers. *Valley Medical Specialists v. Farber*, 194 Ariz. 363, 369–70, 982 P.2d 1277, 1283–84 (Ariz. 1999) (en banc) (decision of trial court that covenant longer than six months was unreasonable was not clearly erroneous where physician was treating patients with chronic conditions whom he saw at least every six months; covenant was held unenforceable in any event because employer’s protectable interests were outweighed by likely injury to patients and public); *Bryceland v. Northey*, 160 Ariz. 213, 217, 772 P.2d 36, 40 (Ct. App. 1989) (two years too long where it took only 14 weeks to train mobile disk jockey replacement); *Amex Distributing Co. v. Mascari*, 150 Ariz. 510, 517–18, 724 P.2d 596, 604–05 (Ct. App. 1986) (36 months too long for a produce broker; several months usually reasonable, more if the relationship is complex; six months or a year is generally upheld); *Compass Bank v. Hartley*, 430 F. Supp. 2d 973, 983 (D. Ariz. 2006) (one-year time frame for financial services employee was sufficient to gain the required confidence of the bank clients to entrust a manager with their investments, but a two-year time frame was unreasonable); *Advantech AMT Corp. v. Foster*, 2009 WL 8629, *5 (Ariz. Ct. App. 2009) (unreported) (nine-month restriction against director of system sales not deemed unreasonable); *ZEP, Inc. v. Brody*, 2010 WL 1381896, *5–7 (D. Ariz. 2010) (customer non-solicitation restrictions of one year found unenforceable where skilled salespeople fully transitioned into customer positions within three weeks of training).

With regard to a sale of business, Arizona courts have enforced longer non-compete agreements without any analysis of the relationship of the buyer’s protectable interests to the time period. *Bonney v. Northern Arizona Amusement Co.*, 78 Ariz. 155, 159–60, 277 P.2d 248, 251–52 (Ariz. 1954) (five years); *Henderson v. Jacobs*, 73 Ariz. 195, 201–02, 239 P.2d 1082, 1086–87 (Ariz. 1952) (five years); *Gann v. Morris*, 122 Ariz. 517, 519–20, 596 P.2d 43, 44–45 (Ct. App. 1979) (10 years); *The Mastro Group, LLC v. American Restaurant Enterprises, Inc.*, 2008 WL 4017948, *3–5 (Ariz. Ct.

App. 2008) (unpublished) (recognizing a more liberal rule for covenants against competition in the sale of a business, affirmed a trial court decision enforcing a 10-year prohibition on operating within three miles of the sold location while remanding for further evaluation on the exact activities prohibited).

4. What geographic limitations have courts recognized as reasonable in the franchise context?

❓ How have they been related to the interests protected?

❓ Have courts recognized the legitimacy of protecting *other* franchisees from competition?

A limited number of Arizona cases have addressed the reasonableness of geographic limitations in the franchise context. In *Snelling & Snelling, Inc. v. Dupay Enterprises, Inc.*, 125 Ariz. 362, 364–65, 609 P.2d 1062, 1064–65 (Ct. App. 1980), the court enforced a restrictive covenant prohibiting competition within 35 miles of the franchisee’s former business to protect the franchisor’s business interests (goodwill and customer contacts). However, the court refused to enforce the portion of the covenant prohibiting competition within 35 miles of other Snelling offices, finding that provision overbroad and not limited to the area where the franchisee had established customer contacts and goodwill. The issue of protection for other franchisees was not addressed. In *First Ascent Ventures, Inc. v. DLC Dermacare, LLC*, 2006 U.S. Dist. LEXIS 77945 (D. Ariz. 2006), the court found a covenant not to compete reasonable when it prohibited related unit and master region franchisees from having any competitive business located in the designated franchise area or within 30 miles of any clinic in the system. The unit franchisee’s territory was a specified territory around Cherry Creek, Colorado, and the master regional franchisee’s territory was the state of Colorado. The court noted that the franchisor would suffer harm from the inability to establish a new franchisee in the former franchisee’s territory with competition from the former franchisees as well as the franchisor’s loss of its actual or potential customer base. *Id.* at *14–20.

In *Furniture Medic, L.P. v. Jantzen*, Bus. Franchise Guide (CCH) ¶ 12,749 (D. Ariz. 2003) (unpublished), the non-compete applied to an area extending one mile from the outer perimeter of the county in which the franchise business was operated, each county adjoining that county, and any county in which another Furniture Medic franchise operated in Arizona. The franchisor had franchisees in Maricopa, Pima, and Coconino counties in the state. Enforcement as written would have prohibited the former franchisee from operating in almost every Arizona county. The franchisor sought only to enforce the geographic scope in Maricopa County and a one-mile perimeter around the county. The court found that Maricopa County was a reasonable geographic scope because the franchisee had advertised “valley-wide services.” The court did not specify whether it was using Arizona or Tennessee law to evaluate the reasonableness of the geographic restriction. (The franchise agreement required application of Tennessee law.) *Id.* at 37,511–12.

In *Fitness Together Franchise Corp. v. Higher Health and Fitness*, 2009 WL 2753026, *1-2 (D. Ariz. 2009) (unpublished opinion), the court enforced a non-compete agreement that prohibited specific fitness services within the former franchisee’s territory or within an eight-mile radius around the territory. The court did not address

whether it considered the geographic limitations to be related to any specific protectable interests. In *In re Saban*, 30 B.R. 534, 539–41 (B.A.P. 9th Cir. 1983), the court found a countywide restriction to be reasonable (although the covenant was ultimately held to be unenforceable because it applied only upon a termination of the contract for breach by the agent and was therefore unenforceable for public policy reasons as a penalty). In *In re Fralc*, 2008 WL 1932311, *2–5 (Bankr. D. Ariz. 2008), an arbitration panel enjoined the terminated franchisee from competing in the designated territory in and around Tucson, Arizona, for a period of two years from the date of the award.

In the employment context, geographic limitations are subject to close scrutiny. Generally, if the prohibited activities are very narrowly defined to protect only the employer's legitimate interests, a wider geographic scope will be upheld. See *Valley Medical Specialists v. Farber*, 194 Ariz. 363, 367–73, 982 P.2d 1277, 1281–86 (Ariz. 1999) (en banc) (five miles from all of employer's offices, covering 235 square miles, was unreasonable where former employee who was a pulmonologist was prohibited from providing any type of medical care; covenant held unenforceable in any event because employer's protectable interests were outweighed by likely injury to patients and public); *Olliver/Pilcher Insurance, Inc. v. Daniels*, 148 Ariz. 530, 532–33, 715 P.2d 1218, 1220–21 (Ariz. 1986) (en banc) (statewide restrictive covenant for insurance salesman would be enforceable if the covenant was only to prevent piracy by former employee; covenant that imposed financial penalty on former employee for customers who independently switched and had no involvement with the former employee was unreasonable); *Lassen v. Benton*, 86 Ariz. 323, 326–27, 346 P.2d 137, 139–40 (Ariz. 1959) (within 12 miles of the city of Mesa enforced to prevent former employee from practicing veterinary medicine or working in a small animal hospital); *Phoenix Orthopaedic Surgeons, Ltd. v. Peairs*, 164 Ariz. 54, 60–61, 790 P.2d 752, 758–59 (Ct. App. 1989) (restriction on practicing orthopaedic medicine or surgery within five miles of any office of a professional corporation enforced); *Alpha Tax Services, Inc. v. Stuart*, 158 Ariz. 169, 171–72, 761 P.2d 1073, 1075–76 (Ct. App. 1988) (statewide anti-piracy restriction on former employee not to solicit employer's clients enforced); *Advantech AMT Corp. v. Foster*, 2009 WL 8629, *5 (Ct. App. 2009) (unpublished opinion) (The rule in Arizona is not that there must be a geographic restriction in every non-compete agreement. The court can enforce a non-compete agreement restricting employment with specifically named companies but without any geographical restriction.).

Arizona courts have refused to enforce non-compete agreements in employment contracts where the geographic scope was too broad. *Safelite Glass Corp. v. Crawford*, 2002 WL 22342, *1–2 (9th Cir. Ariz. 2002) (opinion not for publication or court citation) (25 miles from where salesman was assigned at time of termination, and from any location to which salesman was assigned in the 12 months prior to termination, unenforceable because not narrowly tailored to employer's protectable interest in maintaining its customer relationships; but the dissent by Judge Kleinfeld argues that 25 miles is reasonable for a salesman dealing with institutional customers, and that the provision extending the covenant to 25 miles from other offices could be severed); *Avemco Corp. v. Nichols*, 1995 U.S. Dist. LEXIS 8199, *20–21 (D. Ariz. 1995) (“west of the Mississippi” and a five-state area both held too broad where aviation insurance salesman was prohibited from all competition with former employer; entire state would be reasonable if prohibited activity was very narrow); *Compass Bank v. Hartley*, 430 F.

Supp. 2d 973, 977, 980 (D. Ariz. 2006) (restrictive covenant prohibiting financial services employees from carrying on or engaging in a business that competes with the employer's business within 25 miles of any city where the employee engaged in business, had responsibility over or supervised employees, or otherwise conducted business for the bank was reasonable, but the alternative 50-mile limitation was unreasonable); *Nouveau Riche Corp. v. Tree*, 2008 WL 5381513, *7–8 (D. Ariz. 2008) (covenant restricting employee from operating in four states when she only worked in two states was overly broad, and a restriction prohibiting her from working in any states in which the employer does 10 percent of its business is overly broad without any stated time period for determining the restricted geographical areas).

In the sale of business context, the courts have generally been willing to enforce greater geographic restrictions. See *Bonney v. Northern Arizona Amusement Co.*, 78 Ariz. 155, 159, 277 P.2d 248, 251 (Ariz. 1954) (Coconino County); *Henderson v. Jacobs*, 73 Ariz. 195, 199–200, 239 P.2d 1082, 1084–85 (Ariz. 1952) (Wickenburg area); *Gann v. Morris*, 122 Ariz. 517, 519, 596 P.2d 43, 45 (Ct. App. 1979) (the city of Tucson plus 100 miles); *Arizona Chuck Wagon Service, Inc. v. Barenburg*, 17 Ct. App. 235, 237, 496 P.2d 878, 880 (Ariz. Ct. App. 1972) (Maricopa County).

5. What limitations on activities have courts recognized as reasonable in the franchise context?

In one of the limited number of franchise cases decided by Arizona courts, *Snelling & Snelling, Inc. v. Dupay Enterprises, Inc.*, 125 Ariz. 362, 364–65, 609 P.2d 1062, 1064–65 (Ct. App. 1980), the covenant against competition provided that the franchisee would not engage in a similar business. The court enforced the portion of the restriction that was limited to the geographic area where the franchisee had established customer contacts and goodwill.

The court in *Furniture Medic, L.P. v. Jantzen*, Bus. Franchise Guide (CCH) ¶ 12,749, 37,512 (D. Ariz. 2003) (unpublished) enjoined a former franchisee from owning, participating in, being employed by, consulting with, or having any interest in any other business in the furniture repair or restoration business in the county in which the former franchisee had operated its franchise business. The court evaluated the former franchisee's ongoing business and found that it was not different or distinguishable from the franchised business.

Without any discussion, in *First Ascent v. DLC Dermacare, LLC*, 2006 U.S. Dist. LEXIS 77945, *14–20 (D. Ariz. 2006), the court found reasonable restrictive covenant prohibiting a unit and master region franchisee from owning, maintaining, or having any interest in a “competitive business” located or doing business within the designated franchise area or within 30 miles of a clinic in the system for a period of three years from the date of termination. However, the court declined to issue an injunction prohibiting the former unit franchisee from continuing to operate a skin clinic in the same location due to the franchisor's bad faith.

In *Fitness Together Franchise Corp. v. Higher Health and Fitness*, 2009 WL 2753026, *1–2 (D. Ariz. 2009) (unpublished opinion), the court enforced a permanent injunction only to the extent that the former franchisee's activities involved “one-on-one personal fitness training.” The court specifically noted that the franchisor's complaint alleged that it had developed a unique and proprietary business method for the operation of businesses that offer one-on-one personal training. Because of this de-

scription, the court restricted only that particular business type. The former franchisee was also prohibited from unauthorized use of the franchisor's system or proprietary assets and was required to return any confidential or proprietary information.

Given the paucity of cases addressing restrictive covenants in franchise agreements, the decisions concerning covenants in contracts for the sale of a business and employment agreements provide additional guidance as to the probable limitations that a court will enforce. *Valley Medical Specialists v. Farber*, 194 Ariz. 363, 369–70, 982 P.2d 1277, 1283–84 (Ariz. 1999) (en banc) (covenant which prohibited former employee who was a pulmonologist from providing any type of medical care was unreasonable); *Olliver/Pilcher Insurance, Inc. v. Daniels*, 148 Ariz. 530, 532–33, 715 P.2d 1218, 1220–21 (Ariz. 1986) (en banc) (statewide restrictive covenant for insurance salesman would be enforceable if the covenant was only to prevent the former employee from soliciting the employer's customers, but covenant that imposed financial penalty on former employee for customers who independently switched and had no involvement with the former employee was unreasonable); *Alpha Tax Services. v. Stuart*, 158 Ariz. 169, 171–72, 761 P.2d 1073, 1075–76 (Ct. App. 1988) (statewide antipiracy restriction on former employee not to solicit employer's clients enforced); *Arizona Chuck Wagon Service, Inc. v. Barenburg*, 17 Ct. App. 235, 237, 496 P.2d 878, 880 (Ct. App. 1972) (leasing trucks to a competitor violated covenant not to assist others in the mobile catering business); *Avemco Corp. v. Nichols*, 1995 U.S. Dist. LEXIS 8199, *20 (D. Ariz. 1995) (covenant prohibiting all competition with former employer too broad where employer sold many types of insurance never sold by former employees who only sold aviation insurance).

6. Does the state recognize a difference between interim and post-term covenants?

This issue has not been addressed in the context of franchising. It has been addressed only in the limited context of whether an injunction can be issued to enforce a covenant against competition against a former employee. An Arizona statute prohibits the issuance of an injunction to prevent the breach of a contract, the performance of which would not be specifically enforced. Ariz. Rev. Stat. Ann. § 12-1802.5 (West 1994). In *Titus v. Superior Court, Maricopa County*, 91 Ariz. 18, 20–22, 368 P.2d 874, 876–78 (Ariz. 1962) (en banc), the court distinguished between a negative covenant applicable during the term of employment that would not be enforced (because its purpose would be to enforce indirectly a contract to render services) and a post-term covenant not to compete, which did not require any affirmative act by the former employee. Applying this rationale, a covenant by a disc jockey and news reporter not to be associated with any radio station within 50 miles of Phoenix for one year after the termination of his employment was enforced by the court.

7. Has the state allowed enforcement of covenants against non-signatories (e.g., family members, newly formed corporations)?

This issue has not been addressed under Arizona Law.

8. Will the state modify, “blue-pencil,” or otherwise reduce a covenant found to be overbroad?

Arizona courts will “blue-pencil” (or perhaps more accurately “blue-line”) restrictive covenants to eliminate grammatically severable, unreasonable provisions if it is clear from its terms that the contract was intended to be severable. The court will then enforce the lawful part and ignore the unlawful part. The court will not, however, add terms or otherwise rewrite an agreement. *Snelling & Snelling, Inc. v. Dupay Enterprises, Inc.*, 125 Ariz. 362, 364–65, 609 P.2d 1062, 1064–65 (Ct. App. 1980) (provision of covenant not to compete within 35 miles of franchisee’s area enforceable, while separate provision not to compete within 35 miles of other Snelling offices stricken). See also *Valley Medical Specialists v. Farber*, 194 Ariz. 363, 372, 982 P.2d 1277, 1286 (Ariz. 1999) (en banc); *Olliver/Pilcher Insurance, Inc. v. Daniels*, 148 Ariz. 530, 533, 715 P.2d 1218, 1221 (Ariz. 1986) (en banc); *Amex Distributing Co. v. Mascari*, 150 Ariz. 510, 519, 724 P.2d 596, 605 (Ct. App. 1986); *Compass Bank v. Hartley*, 430 F. Supp. 2d 973, 980 (D. Ariz. 2006). The court in *Farber* did express concern, however, about the *in terrorem* effect of overly broad covenants on departing employees should an employer create an ominous covenant knowing that, if challenged, the court would strike sufficient portions to make it enforceable. The court may also decline to issue a permanent injunction on provisions of a restrictive covenant if the franchisor has “unclean hands.” *First Ascent v. DLC Dermacare, LLC*, 2006 U.S. Dist. LEXIS 77945, *14–20 (D. Ariz. 2006). In *Furniture Medic, L.P. v. Jantzen*, Bus. Franchise Guide (CCH) ¶ 12,749, 37,512 (D. Ariz. 2003) (unpublished), the franchisor elected to enjoin a former franchisee’s activities in only one of the territories in which the franchise agreement prohibited the franchisee from operating without mentioning any “blue-pencil” capabilities.

One federal case applying Arizona law has specifically evaluated the practice of using “step-down” provisions in noncompetition covenants in limited circumstances. These provisions include several scenarios of what may be found by the court to be reasonable. The step-down provision must be carefully crafted. If the provision is indefinite, inconsistent with underlying provisions, or not easily severable from the unreasonable provisions, then the covenant is invalid. *Compass Bank v. Hartley*, 430 F. Supp. 2d 973 (D. Ariz. 2006) (finding that a time and location range was saved by the step-down provisions for “2 years/18 mo./12 mo.” as well as a geographical restriction from engaging in a competitive business within “50 miles (and if 50 miles is determined by the court to be overly broad, then 25 miles),” allowing the court to limit the duration to one-year and the scope to 25 miles). *Id.* at 976–77, 981.

9. When does a non-compete period begin to run?

❓ Will courts equitably extend the term?

The Arizona courts in the franchise cases discussed above have not addressed the issue of when the non-compete period begins except to summarily restate the applicable contract provisions. *Snelling & Snelling, Inc. v. Dupay Enterprises, Inc.*, 125 Ariz. 362, 364, 609 P.2d 1062, 1064 (Ct. App. 1980); *Miller v. Hehlen*, 209 Ariz. 462, 465–66, 104 P.3d 193, 196–97 (Ct. App. 2005); *First Ascent Ventures, Inc. v. DLC Dermacare, LLC*, 2006 U.S. Dist. LEXIS 77945, *14–15 (D. Ariz. 2006); *Fitness To-*

gether Franchise Corp. v. Higher Level Health and Fitness, Inc., 2009 WL 2753026, *1–2 (D. Ariz. 2009) (unpublished opinion). However, in *Furniture Medic, L.P. v. Jantzen*, Bus. Franchise Guide (CCH) ¶ 12,749, 37,511–12 (D. Ariz. 2003) (unpublished), a district court evaluating a franchise agreement with a Tennessee law provision and citing Tennessee case law stated that its equitable powers include “the power to make meaningful the non-competition agreement by making it effective from the date of issuance of any permanent injunction.” The court enforced the full two-year non-compete period from the date of the order. In *Fitness Together*, the court’s injunction issued in August 2009 was only for one year from the January 2009 date of termination, leaving only four months for the non-compete to run. The decision does not indicate whether the franchisor requested equitable tolling or even addressed the time disparity. 2009 WL 2753026, *2.

With regards to employment cases, the Arizona Court of Appeals in *Valley Medical Specialists v. Farber*, 194 Ariz. 363, 370–71, 982 P.2d 1277, 1284–85 (Ariz. 1999) (en banc), remanded down to the trial court to decide whether, given the three-year passage of time since the breach, it would be inequitable to enjoin the former stockholder-employee from practicing in the restricted area from the date of any injunction that the trial court might enter on the remand, even though the employee was operating in the prohibited area at the time of the complaint and there was no indication that he had ceased his actions. This potential flexibility does not appear to have been followed by any other reported cases. In *Varsity Gold, Inc. v. Porzio*, 202 Ariz. 355, 357, 45 P.3d 352, 354 (Ct. App. 2002), the trial court ruled that it would not enjoin an employee from competing because the proscribed time period had already passed. On this issue, an Arizona bankruptcy court questioned an arbitration decision that enjoined the franchisee from competing in the designated territory for a two-year period from the date of the arbitration award instead of the date of termination. The court indicated that it did not believe that it had the power to summarily revise the provision to begin at a different date. However, it remanded the issue of the non-compete starting date to the district court. There was no reported decision resolving the issue. *In re Fralc*, 2008 WL 1932311, *2 (Bankr. D. Ariz. 2008).

10. Are there additional nuances or peculiarities of the state’s treatment of covenants in the franchising context?

Because there are a limited number of cases involving franchising, the nuances and peculiarities under Arizona law are primarily discussed above. The district court’s refusal to grant equitable relief due to the franchisor’s “unclean hands” is one aspect that practitioners will want to evaluate before pursuing an injunction action. Practitioners will also wish to provide for clear step-down provisions in order to provide Arizona courts with the flexibility to enforce what it might find to be a reasonable covenant. One other issue that might arise in the franchising context is whether Arizona courts would refuse to enforce a non-compete that was enforceable under the laws of another state if such enforcement was against Arizona law. This issue has been mentioned in only one Arizona case. In *Snelling & Snelling, Inc. v. Dupay Enterprises, Inc.*, 125 Ariz. 362, 364, 609 P.2d 1062, 1064 (Ct. App. 1980), the parties agreed that Arizona law controlled on the issue of the covenant in question, although the contract specifically provided that it “be interpreted and governed by the laws of the common-

wealth of Pennsylvania.” The court stated that “regardless of whether Pennsylvania or Arizona law applies, the covenant not to compete must be reasonably limited in both time and territory.” This statement implies that Arizona could refuse to enforce a provision that it deems to be unreasonable. *Snelling* in combination with *In re Saban*, 30 B.R. 534, 539 (B.A.P. 9th Cir. 1983), are widely considered to be the controlling case law in Arizona, although *Snelling* is a Division Two case from Tucson. There has been no Arizona Supreme Court case on restrictive covenants in the franchise context.