

POST-TERM NON-COMPETE PROVISIONS IN FRANCHISE AGREEMENTS SHOULD BE REASONABLE¹

Introduction

On March 10, 2023, staff of the Federal Trade Commission (“FTC”) issued a Request for Information (“RFI”) seeking comments from a broad range of stakeholders about how well the franchise business model is working.² The comment period closed on June 8, 2023. The FTC received over 5,200 public comments, of which approximately 2,200 comments were posted to the public record.³ On July 12, 2024, the FTC staff published an Issue Spotlight summarizing what it identified as the top risks to small business success in franchising based on certain of the RFI responses and academic literature, as well as ongoing FTC work in this area.⁴ Of note, the Issue Spotlight identified post-term non-compete clauses in franchise agreements as one of the top-12 franchisee concerns.⁵

The Issue Spotlight included examples of franchisees’ concerns about post-term non-compete clauses. These concerns included: (1) the clauses are inherently unfair to franchisees, (2) they create a restraint on leaving a franchise, (3) they limit competition in the marketplace, and (4) they prevent franchisees from earning a livelihood. Some franchisors commented to the contrary that post-term non-competes are needed to protect the franchise system, other franchisees that join or remain in the franchise system, and franchisors’ trade secrets.⁶

Separate from the RFI regarding the franchise business model, on May 7, 2024, the FTC issued a new rule seeking to ban non-compete agreements in most employment contracts (“Non-compete Rule”).⁷ Because the record in the FTC’s rulemaking process for the Non-compete Rule

¹ This document represents the views of the Franchise and Business Opportunities Project Group (“Project Group”) of the North American Securities Administrators Association, Inc. (“NASAA”) and does not necessarily represent the views of NASAA, any NASAA member, or any state franchise administrator. The Project Group understands that the University of Michigan has undertaken a study of the impact of non-competes in franchise agreements and that the International Franchise Association (“IFA”) may do likewise. The results of these studies may provide useful information in the future.

² *FTC Seeks Public Comment on Franchisors Exerting Control Over Franchisees and Workers* (Mar. 10, 2023), <https://www.ftc.gov/news-events/news/press-releases/2023/03/ftc-seeks-public-comment-franchisors-exerting-control-over-franchisees-workers>.

³ See *Issue Spotlight: Risks to Small Business Success in Franchising*, at 3 [hereinafter, *Issue Spotlight*], https://www.ftc.gov/system/files?file=ftc_gov/pdf/Franchise-Issue-Spotlight.pdf.

⁴ *Id.* In addition to releasing the Issue Spotlight, the FTC reopened the RFI for further public comment and announced additional initiatives. See *FTC Takes Action to Ensure Franchisees’ Complaints are Heard and to Protect Against Illegal Fees* (Jul. 12, 2024), <https://www.ftc.gov/news-events/news/press-releases/2024/07/ftc-takes-action-ensure-franchisees-complaints-are-heard-protect-against-illegal-fees>.

⁵ See *Issue Spotlight*, *supra* note 3, at 11.

⁶ See *id.* at 12.

⁷ See Final Rule: Non-Compete Clause Rule, Federal Trade Commission (16 CFR Part 910), https://www.ftc.gov/system/files/ftc_gov/pdf/noncompete-rule.pdf.

related primarily to non-competes in the employment context, the Non-compete Rule did not apply to non-competes in franchise agreements between franchisors and franchisees.⁸ The Non-compete Rule was scheduled to become effective September 4, 2024. However, on August 20, 2024, a federal court vacated the Non-compete Rule, holding that the FTC lacked adequate authority to enact it.⁹ The FTC has since filed a notice of appeal with the Fifth Circuit Court of Appeals challenging the district court’s order vacating the Non-compete Rule.

The Franchise and Business Opportunities Project Group therefore believes it is timely to provide the Project Group’s guidance on post-term non-compete clauses in the context of the franchise business model. Non-compete laws vary from state to state, and the appropriate scope of any non-compete clause is a fact-specific analysis dependent on the circumstances of each specific situation.¹⁰

Background

Restrictive covenants, more familiarly known as non-competes, made their appearance in English law as early as the 15th century, long before the advent of franchising. They appeared in contracts for the sale of businesses and prohibited sellers from competing with buyers following the sales transactions.¹¹

The law of non-competes was well developed by the time franchising emerged as a business model, and non-competes have become commonplace in franchise agreements. Non-competes in franchise agreements typically address competition both during the term of the franchise agreement and following expiration or termination of the relationship. A simple non-compete in a franchise agreement might provide, for example:

- (a) During the term of this Agreement, Franchisee shall not engage in any competitive business; and
- (b) For [x] years following expiration or termination of this Agreement, Franchisee shall not engage in any competitive business within [y] miles of the franchised location or within [z] miles of any other [franchised brand] location.
- (c) As used herein, the term “competitive business” means

Some states have legislatively limited the permissible scope of non-competes or prohibited them entirely,¹² and federal action could extend such limitations nationally. Where authorized

⁸ See *id.* at 11, 96.

⁹ See *Ryan LLC v. Fed. Trade Comm’n*, Civil Action 3:24-CV-00986-E, 32 (N.D. Tex. Jul. 3, 2024).

¹⁰ See generally Gray, McKnew and Sentell, Eds., *Covenants Against Competition in Franchise Agreements*, 4th ed. (ABA 2023) [hereinafter *Covenants Against Competition*] for a comprehensive review of laws applicable to non-competes.

¹¹ For example, in 1414, enforcement of a non-compete in a business sale was refused in *Dyer’s Case*, 2 Hen. V., fol. 5, sp. 26. Three centuries later, a restrictive provision was enforced in *Mitchell v. Reynolds*, 1 P. Wms. 181, 24 Eng. Rep. 347 (Q.B. 1711).

¹² See, e.g., statutes listed in the attached Appendix.

under applicable law, post-termination non-competes can serve useful purposes in the franchising context. However, enforcement of a broadly worded post-term non-compete may impair or eliminate a franchisee's ability to realize the value of its investment and experience, even to the extent of prohibiting a departing franchisee from continuing in any arguably competitive industry or preventing the franchisee from earning a living wage. Therefore, non-competes should be narrowly drafted and construed to reasonably balance the interests of the parties to the franchise agreement to avoid such consequences.

Discussion

Absent legislative or regulatory approaches, it is timely to consider the appropriate characteristics of a reasonable post-term non-compete in the franchise context. To that end, this guidance addresses:

- I. The Nature of the Franchise Relationship
- II. Expectations of Franchisor and Franchisee
- III. Challenges at the End of the Franchise Relationship
- IV. Reasonable Non-Competes in Franchising

I. The Nature of the Franchise Relationship

Non-competes originated to protect the buyer of a business from competition by the seller of the business, the rationale being that the return on the buyer's investment should not be diminished by the competition from the seller (who had already realized value from the business). This rationale continues to inform non-competes in the sale of businesses.

However, the buyer-seller rationale supporting a post-term non-compete is strained when applied to franchising. The relationship between franchisor and franchisee is fundamentally different from that between the buyer and seller of a business. Usually, the seller of a business transfers ownership of assets and cedes control of the business to the buyer. Post-sale, the buyer can direct and control the business, change the business, and use business assets as it wishes. In a franchise relationship, however, the buyer (franchisee) does not purchase the business *per se*. Instead, a franchisee acquires the right to establish and operate a business for a stated period of time, consistent with a system established and owned by a franchisor. Instead of selling assets or a business to the franchisee, the franchisor grants or *licenses* to the franchisee a temporary right to use the franchisor's assets in that business. In addition to licensing essential assets to the franchisee, the franchisor usually trains the franchisee in the operation of the business, provides operational support, promotes the brand and the system, and monitors system compliance by franchisees, all of which should increase the value of the system.

Assets licensed by the franchisor to the franchisee typically include, among other things:

- (a) Trademarks and/or service marks
- (b) Trade dress
- (c) Trade secrets
- (d) Confidential information
- (e) Know-how

Franchising allows the franchisor to expand and build value in its franchise system using the franchisee's investment rather than (or in addition to) its own capital. The franchise agreement is the license by which the franchisee acquires the right to operate a business using the franchisor's trademarks, trade secrets, and other intellectual property for a specified period of time according to the franchisor's business model using the licensed assets. The franchisee invests its funds in the franchised business but must nevertheless operate in compliance with the franchisor's brand standards, promote and build goodwill in the business, and make regular payments to the franchisor¹³ during the term of the franchise.

II. Expectations of Franchisor and Franchisee

The franchisor and franchisee naturally expect a successful relationship at the onset. Often, however, and despite the language of the franchise agreement, their expectations of the relationship may differ.

The franchisor may expect expansion of its franchise system to increase the value of the brand, market recognition and profitability. In this view, a successful franchisee adheres to the system, shows positive business growth, engages in advertising, pays all fees, makes required changes, and otherwise honors the terms of the franchise agreement.

The franchisee's expectations may be decidedly different. A franchisee may consider itself the owner of the business. Whether the franchisee is an individual who wants to earn a living or a corporate entity who wants a return on investment, the franchisee seeks the ability to make decisions that affect its operations and profitability, and to build value in the business which can be sold or passed on to family. As with many businesses, the franchisee may incur debt to support the business. In short, the franchisee may see the franchised business as an entrepreneurial opportunity, something that the franchisor's sales practices may or may not have encouraged.

Franchise agreements can be antithetical to franchisees' expectations because franchisees are not "owners" of the operating business in the usual sense. As explained above, ultimately a franchisee cannot exercise complete control over the franchised business. The franchisee's ability to operate or change the business, exercise control over its own profitability, or realize the value of its investment through a sale of the business are limited by the franchise agreement.

III. Challenges at the End of the Franchise Relationship

The misalignment in the expectations of the franchisor and franchisee may not materialize until the end of the relationship. At that time, the franchisor can exercise its post-termination rights under the franchise agreement, terminating the franchisee's right to use the franchisor's trademarks and other assets, thereby minimizing or eliminating any potential injury to the goodwill, reputation and value of the brand and the franchise system; maintaining its customers in the now-vacant territory; and perhaps placing another franchisee in the former market space.¹⁴

¹³ These usually include royalties (and/or a comparable premium on required purchases) and other recurring fees.

¹⁴ *E.g., Novus, Inc. v. Livengood*, 2012 WL 38580 (D. Minn. 2012); *Rita's Water Ice Franchise Co. LLC v. S.A. Smith Enterprises, LLC*, 2011 WL 101694 (E.D. Pa. Jan. 11, 2011).

By contrast, the franchisee wants to capitalize on its investment and experience in the business and the general knowledge gained during the franchise relationship, perhaps by operating a business that is in the same or similar industry and/or market space as the franchise. Non-competes may limit or even eliminate a franchisee's ability to do so.

Clearly, the goals of the franchisor and the franchisee at the end of the relationship may conflict and can become acrimonious, depending on the reason for expiration or termination (*e.g.*, as a result of a default or other conflict between the franchisor and the franchisee).

IV. Reasonable Non-Competes in Franchising

In common law, non-competes are enforceable only to the extent they are "reasonable" and narrowly crafted.¹⁵ In the franchising context, the franchisor must have legitimate interests to protect, the scope, duration and geographic reach of the non-compete must be reasonable (*i.e.*, no more extensive than necessary to protect the franchisor's legitimate interests) and the restriction should not materially interfere with the former franchisee's ability to earn a living. The crux of any non-compete analysis is thus whether the non-compete is reasonable in all these respects yet sufficiently narrow to minimize harm to the former franchisee.¹⁶

A non-compete is not the only vehicle available to protect the franchisors' assets. Trademark laws¹⁷ protect the franchisor's brand and trade dress, and trade secrets laws¹⁸ protect the franchisor's trade secrets. In addition, franchisors have additional means of protecting their interests, including post-termination requirements to de-identify the former franchise premises by removing signs and other brand indicia; prohibiting the solicitation of customers of the franchise; barring use or disclosure of the franchisor's confidential information; requiring a departing franchisee to assign URLs to the franchisor, remove or cleanse social media, and refrain from using the franchise trademarks or service marks in search engine optimization or other advertising practices; and affording the franchisor the right to acquire the franchisee's lease and/or purchase the franchisee's business.¹⁹

This raises the question of whether it is reasonable to use non-competes to bootstrap or expand such protections. Are non-competes reasonably used only to address gaps or weaknesses

¹⁵ *E.g.*, *Agrimerica, Inc. v. Mathes*, 199 Ill. App. 3d 435, 557 N.E. 2d 357 (1990); *Piercing Pagoda, Inc. v. Hoffner*, 465 Pa. 500, 351 A. 2d 207 (1976); *Eldridge v. Johnson*, 195 Or. 379, 245 P. 2d 239 (1952). *See also Covenants Against Competition*, *supra* note 10.

¹⁶ *See generally Covenants Against Competition*, *supra* note 10. An initial consideration may be to whom a non-compete should apply: Should funders, investors, or private equity owners who have no role in the operating business be subject to a non-compete?

¹⁷ 15 U.S.C. §§ 1051 *et seq.*

¹⁸ Defend Trade Secrets Act, 18 U.S.C. § 1833(b), and state Trade Secrets Acts.

¹⁹ *E.g.*, *Boulanger v. Dunkin' Donuts, Inc.*, 442 Mass. 635 (2004) (contract by which former franchisee sold franchised location adequately protected franchisor); *7-Eleven, Inc. v. Grewal*, 60 F.Supp.2d 272 (D. Mass. 2014) (de-identification requirements adequately protected goodwill); *Novus Franchising, Inc. v. Dean*, 2010 WL 6421674 (D. Minn. Nov. 29, 2010) (trademark laws and de-identification requirements protected goodwill); *Budget Rent A Car Corp. v. Harvey Kidd Auto*, 249 F.Supp.2d 1048 (N.D. Ill. 2003) (non-compete unnecessary based on affirmative actions by franchisor).

in other protections available to the franchisor? Very few cases have directly addressed the issue, but some courts have implicitly recognized the issue and, where appropriate, have limited non-competes consistent with the scope of these other laws.²⁰

Putting aside the protections otherwise afforded by law to the franchisor's assets, there remain areas which may reasonably require protection through a non-compete. System goodwill, customer relationships, and protection of other franchisees are among these assets. The International Glossary of Business Valuation Terms defines "goodwill" as the "intangible asset arising as a result of name, reputation, customer loyalty, location, products, and similar factors not separately identified."²¹ A franchisor typically views goodwill as brand recognition and reputation of the franchise system built by the franchisor; a franchisee, by contrast, often views goodwill as the result of its own efforts in building a clientele and reputation in its market space.

A reasonable post-term non-compete in franchise agreements requires a balancing of scope, territorial or market reach, duration, and effect on the departing franchisee, weighing the interests of the franchisor, the existing franchisees in the system, and the franchisee exiting the system. Each of these factors will be discussed in turn.

Scope: The restrictive scope of the non-compete is the "competitive business" described in the franchise agreement. The scope of a non-compete may be defined expansively (*e.g.*, any business that is in the same or a similar industry as the franchisor, or any business regardless of type that may compete with the franchisor). A narrower proscription may describe a competitive business as that which offers the same goods or services as the franchised business and/or may include an even more detailed description of goods and services, clientele or other factors characterizing the business operated by the departing franchisee. A more specific, narrower scope of prohibited activities leaves room for a former franchisee to apply its experience in a new venture.

The realities of the market should inform the reasonableness inquiry. For instance:

- What is the actual scope of the former franchisee's franchised business and its current endeavor? If a franchisor operates in a specific niche or subset of a market, courts have found prohibitions beyond that scope to be unreasonable and unenforceable.²² A non-compete that is tailored to protect

²⁰ *E.g.*, *Service Centers of Chicago, Inc. v. Minogue*, 180 Ill. App. 3d 447 (1989) (non-compete clause construed to protect only trade secrets as defined in state trade secret law); *Winston Franchise Corp. v. Williams*, 1992 WL 7843 (S.D.N.Y. Jan. 10, 1992) (same); *Budget Rent A Car of Washington, Inc. v. Raab*, 268 Md. 478, 302 A.2d 11 (Md. 1973) (trademark laws adequately protected goodwill; enforcement of non-compete refused). *See also Novus Franchising, Inc. v. Dean*, discussed above, fn. 15.

²¹ *See* International Glossary of Business Valuation Terms, reproduced at: <https://us.aicpa.org/content/dam/aicpa/interestareas/forensicandvaluation/membership/downloadabledocuments/intl-glossary-of-bv-terms.pdf>.

²² *E.g.*, *Hacienda Mexican Restaurant of Kalamazoo Corp. v. Hacienda Franchise Group*, 569 N.E.2d 661 (Ill. App. 1991) (prohibition from operating any Mexican restaurant overly broad); *ICENY USA v. M&M's LLC*, 421 F.Supp.3d 204 (D. Md. 2019) (restriction narrowed to franchise products only); *Winston Franchise Corp. v. Williams* (non-compete broadly applicable to food industry unenforceable; former franchisee focused on a narrow subset of the larger industry); *Mister Softee, Inc. v. Taikos*, 2014 WL 2535114 (S.D.N.Y. June 5, 2014) (same).

only the market space in which the franchisee actually operated is usually deemed reasonable.

- What is the status of actual competition in the affected area, from the former franchisee, the franchisor's other franchisees and other competitors? If the former franchisee is not competing with the franchisor or the franchisor's other franchisees, enforcement may not be warranted.²³
- Has the former franchisee complied with the franchisor's post-termination requirements to de-identify the business premises, vehicles and signage, reassigned telephone numbers, and ceased using any of the franchisor's marks?²⁴ In the virtual marketplace, has the former franchisee assigned URLs, canceled or cleansed social media, and ceased all use of the franchise brand on websites or in search engine optimization or similar practices. Compliance with such post-termination requirements reduces the likelihood of injury to the brand.
- Can the franchisor use self-help measures to prevent or diminish any potential adverse effects of termination?²⁵ In addition to de-identification requirements, the franchisor can consider exercising options to acquire the lease or the business, or the franchisor can engage in targeted advertising to direct customers to other franchisees.
- Will the post-termination non-compete allow the former franchisee to operate or become employed by a business post-termination?²⁶

Duration: The duration of a non-compete restriction should not be longer than is reasonably necessary to protect the franchisor's legitimate business interests. Again, the realities of the market should be considered. For instance:

- Has the franchisor taken reasonable affirmative actions to protect the brand? In addition to enforcing de-identification obligations, affirmative efforts by the franchisor in the form of advertising or exercising contractual options may eliminate potential adverse injuries.²⁷

²³ E.g., *SH Franchising LLC v. Newlands Homecare*, 2019 WL 356658 (D. Md. Jan. 29, 2019) (former franchisee's operations could not compete with franchise system; enforcement denied); *Physicians Weight Loss Centers of America v. Creighton*, 1992 WL 176992 (N.D. Ohio Mar. 30, 1992) (franchisor failed to demonstrate existence of competition from former franchisee).

²⁴ E.g., *Novus Franchising, Inc. v. Dean* (enforcement declined; former franchisee had complied fully with de-identification obligations).

²⁵ E.g., *Budget Rent A Car Corp. v. Harvey Kidd Auto* (franchisor actions prevent/minimize damage to goodwill).

²⁶ E.g., *Juarez v. Jani-King of California, Inc.*, 2012 WL 177654 (N.D. Cal. Jan. 23, 2012) (enforcement of non-compete declined, during and after franchise term; would have prevented plaintiff from employment in entire industry); *Winston Franchise Corp. v. Williams* (enforcement declined; effect on former franchisee cited).

²⁷ E.g., *Budget Rent A Car Corp. v. Harvey Kidd Auto* (franchisor actions prevent/minimize damage to goodwill).

- How long will it reasonably take the franchisor to replace the franchisee? The more brand demand, the more a shorter period of non-competition may suffice.²⁸
- What is the status of the industry? An innovative industry may command a different approach than a mature one.²⁹

Geography: A non-compete usually includes a description of the area in which the non-compete applies. In franchised businesses that are operated from physical locations, the prohibited area may be described by a distance around the franchised location and may include specific areas around any other franchise-branded location. Some franchises may not limit a franchisee's territory or may be internet-based. Despite the absence of an express territory, the geographical reach of a non-compete enters into the reasonableness analysis. Factors informing the assessment include:

- What exclusive territory, if any, was afforded the franchisee during the term of the franchise? It seems logical that a reasonable area in which the former franchisee cannot operate should not exceed that exclusively reserved to the franchisee in the franchise agreement.³⁰
- In what area did the franchisee operate, and from where did the franchisee's customers originate?³¹ This may help define the reasonable limits of the former franchisee's influence on system goodwill in bricks-and-mortar as well as internet-based or territorially unlimited franchises.
- Can existing franchisees benefit from the former franchisee's departure by capturing the former franchisee's customers? If so, an adverse effect on goodwill may be diminished.
- Is there an existing franchisee available to step into the now-vacant territory? A rapid replacement may allow the replacement to co-opt the goodwill associated with the departing franchisee's operations.

All of these factors illustrate that a non-compete should be drafted as narrowly as possible to protect the legitimate interests of the franchisor yet allow the franchisee to benefit from its investment and experience by operating a different business post-termination.

²⁸ *E.g., In re KBAR, Inc.*, 96 B.R. 158 (Bankr. C.D. Ill. 1988) (one-year is a reasonable time to replace a franchisee).

²⁹ *E.g., EarthWeb, Inc. v. Schlack*, 71 F.Supp.2d 299 (S.D.N.Y. 1999) (duration of non-compete reduced due to dynamic nature of industry).

³⁰ *E.g., Piercing Pagoda, Inc. v. Hoffner*, 465 Pa. 500, 351 A.2d 207 (1976) (non-compete enforced only within franchisee's territory); *H.H. Franchising Systems, Inc. v. Aronson*, 2015 WL 401343 (S.D. Ohio Jan. 28, 2015) (same).

³¹ *E.g., Comedy Club, Inc. v. Improv West Associates*, 553 F.3d 1277 (9th Cir. 2009) (non-compete limited to counties in which former franchisee operated).

Conclusion

Post-term non-competes should be narrowly drawn and reasonable in scope, duration and territory. In the current climate of increased judicial and legislative scrutiny of non-competes, the reasonableness inquiry becomes critical. When drafting or enforcing a post-term non-compete, a franchisor should consider both its position and the positions of existing franchisees and the franchisee leaving the system. Consistent with legal authority, franchisors should prepare a non-compete that reasonably protects the interests of the franchisor and existing franchisees yet allows the former franchisee to realize the value of its investment and experience in the franchised business.

APPENDIX³²

Alabama	Ala. Code §§8-1-190 through 197
California	Cal. Bus. & Prof. Code §16600 <i>et seq.</i>
Florida	Fla. Stat. §542.33
Georgia	Ga. Code Ann. §§13-8-50 <i>et seq.</i>
Idaho	Idaho Code Ann. §§44-2701 <i>et seq.</i>
Illinois	Ill. Freedom to Work Act, 820 ILCS 90/1 <i>et seq.</i>
Indiana	Ind. Code §23-2-2.7-1 <i>et seq.</i>
Iowa	Iowa Code §537A.10
Louisiana	La. R.S. §23:921
Michigan	Mich. Comp. Laws Ann. §445.1527
Minnesota	Minn. R. 2860.3500; Minn. R. 2860.4400 ³³
Montana	Mont. Code Ann. §§28-2-703 <i>et seq.</i>
North Dakota	N.D. Cent. Code §9-08-06
Oklahoma	Okla. Stat. tit. 15, §§217-218
Rhode Island	28 R.I. Gen Laws §§28-59-1 through -3
Texas	Tex. Bus. & Com. Code §15.50-52
Washington	Wash. Rev. Code §19.100.180(2)(i)

³² This Appendix includes state statutes that affect franchise agreements in various ways. Some codify common law, some narrow enforceability, and some define specific conditions surrounding the covenant. This Appendix excludes special industry statutes, state unfair or deceptive trade practice statutes, and state antitrust laws, all of which may apply to non-compete covenants.

³³ These Minnesota regulations are issued pursuant to the Minnesota Franchise Act, Minn. Stat. §§80C.14 and 18.