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Franchising & Distribution Alert

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What does the non-compete ban mean for franchisors and franchisees?

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Brand protection will may require new strategies following the FTC's final rule banning non-competes.

What's the impact?

- Challenges to the Non-Compete Rule are underway, but in the meantime franchisors and franchisees should evaluate their employees' contracts.
- Franchisors should revisit their operational practices and legal documents in anticipation of new limits on non-compete enforcement.
- Private Equity buyers and other investors will need to prioritize analyzing the risks presented by the evolving regulatory approach to non-competes as an integral component of due diligence.

On Tuesday, April 23, the Federal Trade Commission announced its final rule banning non-competes (Non-Compete Rule). Legal challenges have already been filed, but the Non-Compete Rule will go into effect 120 days after the publication of the rule in the Federal Register (the Effective Date) if not otherwise enjoined. Although non-competes between franchisors and

franchisees are expressly excluded from the Non-Compete Rule, the complexity of franchise relationships complicates requires careful consideration of the new rule.

What to do now

In general, franchisors and franchisees (and their direct employees) will be affected the same way that all businesses will be affected. As of the Effective Date of the Non-Compete Rule:

- New non-competes with all workers will be prohibited.
- Existing non-competes with workers other than senior executives will be unenforceable.
- It will be considered an unfair practice to represent that a worker is subject to unenforceable non-compete.
- Any person or business that entered into a non-compete made unenforceable by the Non-Compete Rule must notify the worker of the unenforceability prior to the Effective Date of the Non-Compete Rule.

Franchisors and franchisees should consider their contracts with their respective employees and consult with counsel as needed to ensure compliance with these requirements.

How to think about brand protection moving forward

Historically, franchisors have relied on a combination of non-competes, non-solicitation provisions, and confidentiality covenants to protect their proprietary information and safeguard brand goodwill. This means that many existing franchise agreements may recommend or require that franchisees obtain non-competes or similar covenants from certain personnel to ensure the confidentiality and protection of trade secrets and other proprietary brand information. Because non-competes may no longer be in the "toolkit," additional steps are now recommended.

First, it is incumbent on franchisors to revisit their legal documents, operations manuals, and standard recommendations, to ensure any current recommendations will not run afoul of the new ban on non-competes.

Second, franchisors should review their past practices to determine whether any historical agreements trigger the notification requirements under the Non-Compete Rule, and to ensure that other covenants are in place to protect the proprietary information previously protected by non-competes.

Third, franchisors should review their general practices related to trade secrets and proprietary information to ensure that their operational practices and legal documents provide the maximum protection available under state law, even in the absence of enforceable non-competition covenants. For example, too-broad definitions of confidential information, or an inability to show that a franchisor has gone above and beyond to protect that information that is

considered a "trade secret," might make it more difficult to pursue a former employee for the improper use of such proprietary information.

For potential private equity franchisor investors, or other parties involved in franchise mergers and acquisitions, analyzing the risks presented by the evolving regulatory approach to non-competes and a franchisor's ability to protect its proprietary information may become an important due diligence item.

Long term ramifications

Longer term, franchisors and franchisees should not expect this to be the last word on non-competes in the franchise context. The FTC's commentary regarding non competes was clear that "franchisor/franchisee non competes may in some cases present concerns under Section 5 [of the FTC Act] similar to the concerns presented by non competes between employees and workers." The primary reason for the FTC's decision to exclude franchise relationships from the non-compete ban was the lack of evidentiary record related to the same. This absence may serve as an implicit invitation for state lawmakers concerned about the protection of franchisees in franchisor and franchisee relationships, to consider extending a similar ban imposing a similar ban in the franchise context.

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