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Federal Trade Commission
Office of the Secretary
600 Pennsylvania Avenue, NW
Suite CC-5610 (Annex C)
Washington, DC 20580

RE: Non-Compete Clause Rulemaking, Matter No. 201200

Federal Trade Commission:

The Franchise and Business Opportunities Project Group[1] of the North American Securities Administrators Association ("NASAA Franchise Project Group") appreciates the opportunity to respond to the Federal Trade Commission's (the "Commission") request for comments on whether franchisor/franchisee non-compete clauses should be covered by the proposed Non-Compete Clause Rule, 16 C.F.R. Parts 910 (the "Proposal").[2]

Who We Are

Organized in 1919, NASAA is the oldest international organization devoted to investor protection. NASAA's membership includes the securities administrators in the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Canada, and Mexico. In the U.S., NASAA is the voice of state securities agencies responsible for grass-roots investor protection and responsible capital formation. NASAA develops model statutes, rules and guidelines for adoption by individual states, and NASAA members also participate in cooperative enforcement projects, information-sharing, and training and education of state securities regulators.

Several NASAA members[3] administer and enforce state franchise registration and disclosure laws. As part of those duties, those states require that franchisors file their Franchise Disclosure Documents ("FDDs") with state franchise agencies prior to offering or selling in the state. Those states also employ franchise examiners to review and comment on those FDDs

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1 The following comments reflect the views of the Franchise and Business Opportunities Project Group, and do not necessarily represent the views of NASAA.

2 The Proposal is available at https://www.regulations.gov/document/FTC-2023-0007-3959.

3 California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin.

before the state grants the franchisor a registration of its franchise offering. As a result, state franchise regulators review thousands of franchise agreements and related FDDs each year. Our experience with reviewing these documents affords us an insight into current trends in franchising and the unique nature of the franchisor/franchisee relationship.

More than 30 years ago, NASAA established a standing committee, now called the Franchise and Business Opportunities Project Group (the "Franchise Project Group"), to provide a forum where regulators could address issues relating to franchises and business opportunities. The Franchise Project Group studies and makes recommendations to NASAA about model acts, statements of policy, and interpretive commentaries that will benefit investors of franchises and business opportunities and those industries.

The Franchise Project Group welcomes the opportunity to comment on the statements made in the Proposal[4] regarding franchisor/franchisee non-compete clauses. Our comments are limited to franchisor/franchisee non-compete clauses that arise following the termination of the franchise agreement ("post-term" clauses).

1. The Proposal Should Cover Franchisor/Franchisee Post-Term Non-Compete Clauses.

In the Proposal, the Commission recognizes that non-compete clauses in the employment context could potentially stifle new business formation and innovation, reduce the earnings of franchisees, and have other negative effects on competitive conditions similar to non-compete clauses between employers and workers. The Proposal would exclude franchisees from the definition of workers based on a theory that the relationship between franchisor and franchisees may, in some cases, be more analogous to business-to-business relationships than employment relationships. In fact, while most franchisees may not qualify as "employees," the relationship between franchisor and franchisee is not analogous to most business-to-business relationships.[5] Franchisor/franchisee post-term non-compete clauses have the same negative effects on competition as non-compete clauses in the employment context.

In most non-franchised businesses, a business owner develops its own brand and intellectual property, has full control over its own operations, and has decision-making authority over its overall and day-to-day operations. In contrast, in franchising relationships, the franchisor reserves a significant amount of unrestricted decision-making authority over business operations under the franchise agreement. The franchisee owns the assets needed to provide the product or service but must agree to follow the franchisor's brand control and operational

[4] The numbered sections of this letter respond to the comments the Commission specifically requested comment on at paragraph D, "Coverage of Non-Compete Clauses Between Franchisors and Franchisees." Proposal at 153-54.

[5] Franchisors have in some cases been successfully sued by franchisees who claimed that they are employees, despite the franchisor calling the relationship a franchise. *See*, *e.g.*, *Roman v. Jan-Pro Franchising Int'l, Inc.*, 342 F.R.D. 274, 291 (N.D. Cal. 2022).

directives.

Many first-time franchisees are inexperienced businesspersons, seeking to operate a small business with the benefit of the franchisor's expertise. The seasoned franchisor offers experience, a proven track record, corporate services, and ideally a recognizable trademark. The franchisee makes large investments to establish a franchise outlet, which includes sunk costs that it can no longer recover if the franchise outlet fails or is terminated. Franchisors risk the reputational value of their intellectual property, including trademarks, in exchange for shifting the cost of significant capital investments to franchisees. The franchisee relies on the franchisor's business knowledge and follows the franchisor's system. The franchisee is wholly dependent on the franchisor to develop a successful system and to share its expertise with the franchisee.

The franchise business model is, with rare exceptions, a long-term relationship between unequal parties. An exercise of the franchisor's control may easily threaten a franchisee's investment. It is also possible for a franchisee to harm the franchisor's trademark if it fails to maintain the franchisor's quality controls, but the balance of power is ultimately in the franchisor's favor. This is because franchise agreements typically include clauses that aggressively protect franchisor interests and grant the franchisor significant discretion under the business judgement rule to provide the franchisor ultimate control over the franchise.

The franchisor/franchisee relationship creates a power imbalance where, in many cases, the franchisor can opportunistically use its discretion to cause the franchisee to close or terminate the franchise outlet. If the outlet closes before the end of the franchise term, it is likely to result in the loss of the franchisee's life savings and livelihood. Further, as discussed below, franchisees who are ousted from the system cannot recoup their investment by selling their businesses at full value and are prevented by many post-term non-compete clauses from using their skills and experience to earn a livelihood. The franchise business model places the franchisee in a very vulnerable position with the franchisor. This power imbalance is demonstrated in franchise disputes where the franchisee claims that an established standard violation was only a pretext for termination.[6] Another example is when the franchisor exercises its power and modifies the franchise system.[7]

The Commission understates the prevalence of non-compete clauses in franchising when it describes that "many" franchise agreements may contain non-compete clauses. A 1995 law review article describes non-compete clauses in franchise agreements as "virtually ubiquitous."[8]

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[6] N.Y. Times, *Subway Got Too Big. Franchisees Paid a Price* (June 28, 2019), *available at* https://www.nytimes.com/2019/06/28/business/subway-franchisees.html.

[7] N.Y. Times, *When Private Equity Came for the Toddler Gyms* (Jan. 28, 2023), *available at* https://www.nytimes.com/2023/01/28/business/economy/little-gym-private-equity.html.

[8] *See* Robert W. Emerson*, Franchising Covenants against Competition,* 80 IOWA L. REV. 1049, 1050-51 (1995) (the author obtained copies of 100 then-current standard forms of franchise agreements used by franchisors

Based on the experience of members of the NASAA Franchise Project Group, it is extremely rare for a franchise agreement not to include both an in-term and a post-term covenant not to compete. Non-compete clauses are so prevalent because of the unequal bargaining power between franchisors and franchisees. The concern with such non-compete clauses is that they prevent franchisees from earning a living in the very field where they have training and experience.[9] In some cases, franchisees have either left their prior careers to start a franchise or they have worked many years in the industry before purchasing or converting their existing business to a franchise. These franchisees, like employees, would be prevented from using skills they developed before they bought a franchise. Post-term non-compete clauses negatively affect competition in product and service markets in the same ways that have been evidenced in the traditional employer/employee relationship.

For these reasons, the NASAA Franchise Project Group recommends to the Commission that the Proposal should also cover franchisor/franchisee post-term non-compete clauses.

2. The Franchisor/Franchisee Non-Complete Clause Should Be Categorically Banned Once the Franchisee Leaves The Franchisor's System.

Post-term non-compete clauses are subject to stricter scrutiny in employment contracts than those connected with the sale of a business.[10] When purchasing a business, a buyer is purchasing the seller's goodwill along with the other tangible and intangible assets of a company, such as equipment, property, and intellectual property and branding. The buyer is in a vulnerable position should the seller open a competing business in the same neighborhood. The seller has the ability to diminish the value of the business, so the buyer may seek to add a non-competition agreement to the sale and purchase agreement to better protect their investment.

In contrast to the typical sale of a business, franchise agreements create a long-term relationship between unequal parties. It is not an arm's length transaction between a buyer and seller on equal footing. In the franchisor/franchisee relationship, the franchisor has retained control of the intellectual property and operations of the franchise business. The franchisee has invested significant capital into the business and is at risk of losing the investment if the franchise outlet closes, is terminated, or is not renewed. At the end of the relationship, the franchisee must de-identify with the franchisor brand and must seek a new livelihood.

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to verify the frequency and general content of various provisions, and found that 98% of those agreements contained covenants against post-termination competition).

9 *See* Public comment of Anonymous (Jan. 9 2023), *available at* https://www.regulations.gov/comment/FTC-2023-0007-0122; Public comment of Anonymous (Jan. 9 2023), *available at* https://www.regulations.gov/comment/FTC-2023-0007-1945; Public comment of Tim Rusch (Jan. 12, 2023), *available at* https://www.regulations.gov/comment/FTC-2023-0007-1585.

10 Restatement (Second) of Contracts sec. 188, cmt. g (1981) ("Postemployment restraints are scrutinized with particular care because they are often the product of unequal bargaining power and because the employee is likely to give scant attention to the hardship he may later suffer through loss of his livelihood.")

Consequently, the policy arguments for enforcing non-compete clauses in traditional business contracts are not applicable in the franchise context. The franchisor is not a new business buyer who needs to protect its capital investment in a new business. It is the exact opposite. It is the franchisee who is at risk with a large sunk investment in the franchise system under the control of the franchisor. If the franchisor chooses to buy the franchisee's outlet at termination, it may continue to operate the former franchise outlet as a company-owned store or sell to a new franchisee, either option potentially provides a significant profit to the franchisor at the franchisee's expense. Consequently, restricting the franchisee from forming a new business that could potentially compete with its former franchisor is an unreasonable restraint of trade.

There is another distinction between the traditional sale of a non-franchised business and the end of a franchise relationship that weighs heavily in favor of a categorial ban on post-term non-competes in the franchise context. In the traditional sale of a non-franchised business, the seller receives a purchase price for the value of the business from the buyer, which includes not just assets but also goodwill. The sale also can include a non-compete for a limited period after the sale in a certain geographic area. As the Commission noted, the proceeds from the sale will often provide a financial cushion to a seller such that agreeing to a non-compete provision does not place an undue hardship on the seller. Franchisees do not have the same benefit; when their outlets close or are terminated, they are lucky if they receive any payment for the value of the assets, often at a discounted price.[11] In a traditional business sale, the assets being sold will typically include intellectual property, customer lists, and goodwill, which can often be the most valuable part of the transaction; in the franchise closure or termination context, these valuable assets are already owned by the franchisor, and the franchisee will not receive any proceeds for these assets. At most, franchisees often receive payment only for physical assets like equipment or inventory. Thus, in many cases, any payment a franchisee receives at the closure or termination of their franchise is unlikely to be sufficient to support the franchisee or their families while they are subject to a post-term non-compete that prohibits them from working in the industry in which they have just spent many years doing business.

In addition, although franchisors currently use non-competes to protect their intellectual property, trade secrets, or other confidential and proprietary information, they do not need to do so. Franchise agreements already include other clauses that protect the intellectual property and trademark(s) of the franchisor. Franchise agreements contain confidentiality clauses, and if they do not, franchisees and their employees are usually required to sign confidentiality agreements or non-disclosure agreements agreeing that they will not disclose intellectual property, trade secrets, or other confidential or proprietary information, both during and after the term of their franchise agreement or employment. Franchisees who go on to open a new business or take a job with another business in the same industry would be barred from using the franchisor's proprietary information, making it unnecessary to impose additional restrictions on a franchisee. It is true that a portion of franchisees are more akin to senior executives than employees because they are

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[11] Some states have adopted franchise relationship laws requiring the franchisor to purchase assets of the business at fair market value. *See*, *e.g.*, the California Franchise Relations Act, Cal. Bus. & Prof. Code §§ 20000 to 20043.

privy to confidential or proprietary information. But the Commission acknowledges in the Proposal that even for highly skilled workers or senior executives, there are competitive harms that result from non-competes. The Commission should view franchisees as being exposed to the same competitive harms. If access to confidential and proprietary information justifies the use of non-competes, then there would be no logical grounds to prohibit non-competes in the employment context at all. Non-compete clauses are an overbroad tool if the goal is only to protect intellectual property, trade secrets, or other confidential and proprietary information.

For these reasons, the NASAA Franchise Project Group recommends to the Commission that franchisor/franchisee post-term non-compete clauses be categorically banned as an unfair method of competition. Doing so would increase competition in the labor market, create jobs, and increase innovation and new business formation.

3. The Rule Should Apply Uniformly To All Post-Term Non-Compete Clauses With No Exemptions Or Different Standards.

As explained in the previous paragraph, the typical franchise relationship is aimed at prospective franchisees who do not have a product or the skills to start their own businesses. This dynamic places the franchisee in a dependent relationship with the franchisor. Moreover, franchisors almost universally grant non-exclusive territories to franchisees,[12] thus allowing a franchisor to potentially become the franchisee's biggest competitor. There is no reasonable justification to distinguish between kinds of business formats when the franchisor/franchisee relationship allows aggressive competition by the franchisor with its franchisees in most, if not all, business formats.

The franchisor can compete with the franchisee when it is part of the franchise system but wants to restrict competition when the franchisee separates from the franchise system. This reflects the power imbalance in the franchisor/franchisee relationship and simply results in an unfair method of competition.

For these reasons the NASAA Franchise Project Group recommends to the Commission that the proposed rule should apply uniformly to all such post-term non-compete clauses with no exemptions or different standards.

4. Alternative to Categorical Ban: A Rebuttable Presumption That Post-Term Non-Compete Clauses are Unfair and Prohibited in the Franchising Context.

Although the NASAA Franchise Project Group recommends that the Proposal cover franchisor/franchisee post-term non-compete clauses, and that such clauses should be categorically banned, the NASAA Franchise Project Group proposes the following alternative

[12] Franchise Rule Compliance Guide, Item 12, page 73: "You will not receive an exclusive territory. You may face competition from other franchisees, from outlets that we own, or from other channels of distribution or competitive brands that we control."

should the Commission determine that a complete ban is not warranted. If the Commission does not include franchises in the Proposal, or does not categorically ban post-term non-compete clauses in franchise agreements, the NASAA Franchise Project Group recommends that non-compete clauses in franchise agreements should be subject to a rebuttable presumption that post-term non-compete clauses are unfair and prohibited in the franchising context.

A narrowly tailored non-compete could be appropriate in tightly limited circumstances; namely, if a franchisor can show that there is in fact intellectual property, trade secrets, or other confidential or proprietary information that a franchisee would be using in future business endeavors or future employment with a competitor. In such a circumstance, the franchisor should be required to prove that any business activity or employment role that a franchisee takes is inextricably linked to the use of the franchisor's confidential or proprietary information, trade secrets, and trademarks, or other intellectual property, such that a complete prohibition on the franchisee's ability to pursue a post-term livelihood in the same industry would be necessary. That is, franchisors should be required to prove there would be no way for the franchisee to operate a business or be employed by a business without using the franchisor's confidential or proprietary information, trade secrets, and trademarks, or other intellectual property of the franchisor. Such a determination could be subject to a rule-of-reason analysis that weighs the franchisee's right to earn a living with a legitimate interest in protecting intellectual property. However, the bar to rebut the presumption would need to be high to protect franchisees from the negative effects of post-term non-competes that affect employees and to limit the detrimental effects of non-competes on competition.

Conclusion

NASAA and the Franchise Project Group stand ready to work with the Commission staff to review issues impacting the franchise industry, and we appreciate the opportunity to comment on this important matter. Should you have any questions, please feel free to contact the undersigned (theresa.leets@dfpi.ca.gov), or NASAA's General Counsel, Vince Martinez (vmartinez@nasaa.org).

Very Truly Yours,

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