Lathrop GPM

Lathrop GPM LLP
lathropgpm.com

80 South Eighth Street
500 IDS Center
Minneapolis, MN 55402
Main: 612.632.3000

600 New Hampshire Avenue, N.W.
The Watergate – Suite 700
Washington, D.C. 20037
Main: 202.295.2200

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Via Electronic Submission

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

RE: Noncompete Clause Rulemaking – Matter No. 9201200

The Lathrop GPM LLP Franchise & Distribution Practice Group submits these comments in response to the January 19, 2023 Notice of Proposed Rulemaking ("NPRM") issued by the Federal Trade Commission regarding non-compete clauses. *See* 88 Fed. Reg. 3482 (Jan. 19, 2023).

Background of the Lathrop GPM Franchise Group

Lathrop GPM's Franchise and Distribution Practice Group currently comprises approximately 27 lawyers and other professionals who practice franchise law almost exclusively. The group is split fairly evenly between transactional lawyers and litigators. The comments in this letter reflect input from both sides of the Franchise Practice Group.

Lathrop GPM's Franchise Practice Group has been an integral part of the firm for over sixty years since John Mooty (namesake of the predecessor Gray Plant Mooty firm) became an owner of National Car Rental in 1959 and established its franchise program to grow the company to one of the largest car rental companies in the United States. John Mooty also acquired a controlling interest in American Dairy Queen in 1970 and functioned as its Chairman for over

twenty years while the company grew to be one of the most recognized and successful franchise brands in the United States. During this time, the Franchise Practice Group grew in size and significance. Lathrop GPM, and its predecessor firm, Gray Plant Mooty, have represented thousands of franchise companies, from small startups to some of the most recognizable brands in the world.

Lathrop GPM's lawyers are intimately familiar with the process of drafting enforceable noncompete provisions, as well as enforcing them on behalf of franchisors throughout the United States. Over the last sixty years, attorneys from Lathrop GPM and its predecessor have prosecuted noncompete enforcement actions in thousands of cases in virtually every state in the United States. Further, Lathrop GPM attorneys have edited all four editions of the seminal franchise noncompete book published by the American Bar Association since 1992. *See* "Covenants Against Competition in Franchise Agreements," American Bar Association Forum on Franchising (4th ed. 2022). Peter Klarfeld was editor of the first two editions in 1992 and 2002 and Michael Gray co-edited the third and fourth editions in 2012 and 2022. It is with this deep history and knowledge of franchise noncompete law that the authors express their opinions in this letter. A rule that undermines the enforceability of reasonable noncompete clauses in franchise agreements would eviscerate a well-established body of law that has been a significant part of the orderly relationship between franchisors and franchisees for over six decades.

Introduction and Summary

To the extent that the Commission promulgates any rule that purports to affect the enforceability of contractual noncompete clauses as suggested in the NPRM,[1] it should expressly

[1] Lathrop GPM understands that many industry groups intend to submit comments challenging the merits of the proposed rule generally and the Commission's authority to promulgate the rule under the

exclude application to non-compete clauses in agreements between franchisors and franchisees. Any expansion of the proposed rule to cover noncompete clauses entered into as a component of the franchisor-franchisee relationship would be contrary to the overwhelming weight of legal authority establishing that such clauses are valid and enforceable so long as they are reasonable in scope and duration. As the NPRM appears to concede (88 Fed. Reg. at 3511), departure from the longstanding rules governing the enforceability of noncompete clauses in the franchise relationship cannot be justified on grounds of public policy. To the contrary, decades of experience demonstrate that noncompete clauses in the franchise context protect legitimate interests of both franchisors and franchisees and that violations of those provisions can cause irreparable harm sufficient to justify entry of preliminary and permanent injunctive relief. The Commission should not eviscerate these long-standing protections under the guise of promoting fair competition.

From our experience drafting franchise agreements and enforcing their terms, covenants not to compete have long been virtually ubiquitous in the agreements that establish the franchise relationship. Through its Franchise Rule promulgated in 1979 and amended in 2007, the Commission has regulated certain aspects of the franchise industry for over forty years, and many states have enacted franchise disclosure and relationship statutes that govern the franchise relationship. *See*, *e.g.*, 16 C.F.R. Part 436; Ark. Code § 4-72-207; Cal. Bus. & Prof. Code § 20000 *et seq.*, Minn. Stat. § 80C.01 *et seq.* Some of these statutes prohibit certain provisions in franchise agreements, or render them unenforceable as a matter of public policy. *See, e.g.*, Cal. Bus. & Prof.

authority of Section 5 of the FTC Act. Rather than submitting potentially duplicative comments on these broader issues, the present comments focus on the franchise-specific issues to which the NPRM specifically invited comments. *See* NPRM, 88 Fed. Reg. at 3520. This limited focus is not intended to suggest that the balance of the proposed rule described in the NPRM is either justified as a matter of policy or within the Commission's limited statutory authority.

Code § 20040.5; Minn. Stat. § 80C.21. But neither the Commission nor the states that have regulated franchising have ever taken the position that covenants not to compete in franchise agreements should be prohibited or unenforceable.[2] As a consequence, and absent unusual circumstances that may arise on case-by-case basis, most courts considering reasonable covenants not to compete find them to be enforceable in the franchisor/franchisee context. As the NPRM concludes, albeit with far more equivocation than necessary, there is no basis in law or policy for the Commission to eviscerate this well-established body of law.

In the franchise context, and over the course of many decades, courts consistently have found that reasonable post-termination covenants not to compete support numerous legitimate interests, including protection of confidential information, protection of the franchisor's goodwill associated with its trademarks and operations at a particular location, incentivizing system development and training of franchisees, and protection of the franchise system (including other franchisees) from illegitimate competition. These decisions are compiled on a state-by-state basis in the American Bar Association Forum on Franchising's book, *Covenants Against Competition in Franchise Agreements*, which was originally published in 1992 and is now in its fourth edition. A member of the Lathrop GPM Franchise Group has served as editor or co-editor of every edition of this publication, which identifies and describes hundreds of reported decisions by federal and state courts throughout the United States, Canada, Puerto Rico, the U.S. Virgin Islands, and Mexico. Further, as the decisions cited in the *Covenants* book reflect, courts routinely find that

[2] As discussed in the NPRM, a small minority of states generally prohibit contractual covenants not to compete as a matter of state law. 88 Fed. Reg. at 3494 (noting 47 states in which "at least some non-compete clauses may be enforced"). Even in some of these states that are generally considered more hostile to contractual covenants not to compete, however, reasonable covenants entered into a part of the franchise relationship may be enforceable. *See, e.g., Bambu Franchising, LLC v. Nguyen*, 537 F. Supp. 3d 1066 (N.D. Cal. 2021) (enforcing noncompete covenant in franchise agreement under California law).

franchisors and franchise systems will suffer irreparable harm sufficient to justify a preliminary or permanent injunction when a former franchisee violates the noncompete covenant. The essential conclusion from the wealth of reported decisions is that reasonable post-termination covenants in the franchise context should be enforced, and that those agreements that exceed the bounds of reasonableness can be limited or deemed unenforceable by the courts based upon the particular facts of each case. There is no basis for a regulatory evisceration of this entire body of case law, and the NPRM suggests none.

The NPRM states in proposed 16 C.F.R. § 910.01(f) that "[t]he term worker does not include a franchisee in the context of a franchisor-franchisee relationship." 88 Fed. Reg. at 3535. In our view, maintaining this express exclusion is essential if the Commission promulgates any rule regulating covenants not to compete. The same provision of the proposed regulation goes on to state that "[n]on-compete clauses between franchisors and franchisees would remain subject to Federal antitrust law as well as all other applicable law." *Id.* This language is unnecessary surplusage; we are not aware of any claim that covenants not to compete enjoy some categorical exemption from the federal antitrust laws, although (as the Commission presumably is aware) there is no precedent holding that a routine covenant not to compete between a franchisor and a franchisee would violate these laws under the rule of reason, or otherwise.

For the reasons stated above, the Lathrop GPM Franchise Group fully endorses the NPRM's express exclusion of covenants not to compete between a franchisor and a franchisee from any proposed regulatory restriction. We note, however, that while reaching the correct conclusion (at least as to covenants contained in franchise agreements), the Commission's discussion of franchising in the NPRM contains numerous statements that are speculative, unsupported, flatly wrong, or gross mischaracterizations. Among other examples, the NPRM states

that franchisor-franchisee agreements are "*more analogous to* the relationship between two businesses than the relationship between an employer and a worker." 88 Fed. Reg. at 3520 (emphasis added). This statement is misleading because it not a matter of analogies; franchise agreements do in fact establish a relationship between two businesses as opposed to creating an employment relationship. The claim that covenants in franchise agreements "could potentially stifle new business formation and innovation, reduce the earnings of franchisees, and have other negative effects," *id.*, is unsupported by any objective data and speculative, as the "*potentially*" caveat in the NPRM reveals. In our experience, any "new" business that results from violation of a franchise noncompete covenant is usually a partially rebranded version of the previously franchised business; there is no net gain in new businesses from these occurrences. To the contrary, existing franchisees will be disincentivized from opening additional new franchised outlets if they face unfair competition from "rebranded" former franchisees trained by their franchisor and using its systems to compete unfairly against them. Finally, the NPRM's claim about supposedly exploitative and coercive agreements, *id.*, is a tired mischaracterization. Among other reasons, the Commission's Franchise Rule mandates extensive pre-sale disclosures that provide relevant information to a prospective franchisee, including noncompete terms. A franchised business opportunity cannot reasonably be deemed a necessity that a potential franchisee is required to purchase, and not even the largest national franchisors hold a monopoly or near-monopoly on sales of business opportunities. In sum, while the Commission reaches the correct conclusion in excluding franchisor-franchisee covenants from the proposed rule, the factual basis supporting the conclusion relies upon a substantially misguided discussion of franchising that makes the question appear closer than it really is. The foregoing issues are discussed in greater detail below.

Importance of Noncompete Agreements in the Franchise Context

The franchise relationship is unique and, as the NPRM seems to recognize, is not an employment relationship. The California Supreme Court, too, has recognized that "franchising is different" from typical methods of distribution where a company uses its own employees and other assets to operate chain or branch stores. *Patterson v. Domino's Pizza, LLC*, 60 Cal. 4th 474, 478 (2014). Considering this fundamental difference, the "ubiquitous, lucrative, and thriving" nature of franchising, and the profound effects it has on the economy, the *Patterson* Court concluded that the usual tests for "determining the circumstances under which an employment or agency relationship exists" did not apply in the franchise context. *Id.* at 477, 489, 503. Courts have long held that franchisees are independent business owners, not employees. *GTE Sylvania Inc. v. Continental T.V., Inc.*, 537 F.2d 980, 989 (9th Cir. 1976). Converting franchisees into employees would "completely disrupt the franchise relationship" and franchisees who willingly decide to buy a business for its potential profit would be forced to give up the right to a profit stream for a paycheck. *Patterson*, 60 Cal. 4th at 488, 498.

The franchise relationship is interlaced with issues of trademark law and requires the use, under a license, of a franchisor's trademarks, trade secrets, and confidential information. Considering these hallmarks of the franchise relationship, noncompete agreements serve a vital function that benefits franchisors and franchisees alike. As discussed further below, federal and state courts across the country for decades have recognized that noncompete agreements are necessary to protect several legitimate business interests of the franchisor, including (a) the franchisor's investment in developing a franchise system and brand, (b) the goodwill associated with the franchisor's trademark and business system at given locations, (c) confidential information and trade secrets, and (d) the ability to re-franchise locations or territories.

Noncompete agreements also benefit franchisees by protecting their investment, guarding against unfair competition, and avoiding training and setting up direct competitors.

For centuries, courts have recognized the legitimate interests a noncompete may serve. *Mitchell v. Reynolds*, 24 Eng. Rep. 347 (Q.B. 1711). Since English courts recognized the legitimate interests a noncompete agreement may serve centuries ago, courts in every jurisdiction in the United States have done the same while simultaneously imposing some limitation(s) on the scope of enforceable noncompete agreements. The near-uniform approach is that noncompete agreements must be reasonable in scope—including time, geographic reach, and activities covered—and no broader than necessary to protect the legitimate business interests of the promisee. Thus, the courts strike a careful balance between the competing interests – a balance that would be entirely lacking if reasonable noncompete covenants were wiped out by administrative fiat.

"Generally speaking in franchise law, courts favor enforcement of non-competition agreements and find irreparable harm when former franchisees violate such provisions." *Goddard Systems, Inc. v. Gondal*, C.A. No. 17-1003-CJB, slip. op. at 59 (D. Del. Mar. 29, 2019).

> In a standard franchise agreement, the franchisor allows the franchisee to use its marketing materials, trademarks, trade secrets, and client lists to set up a new business. In return, the franchisee typically pays a fee for the right to operate that franchised business. But what happens when the franchisee later wants to strike out on her own? If, as is normally the case, her franchise agreements contain noncompetition clauses, she must either wait until the specified period has passed or move outside the specified geographic area.

Fitness Together Franchise, LLC v. EM Fitness, LLC, 2020 WL 6119470 (D. Colo. Oct. 16, 2020). Despite Colorado policy generally disfavoring enforcement of noncompete agreements, the court in *Fitness Together* held that noncompete agreements that protect trade secrets and apply to

professional staff are enforceable generally, and in this case specifically, where the franchise noncompete agreement only covered a three-mile radius for one year. *Id.* at *9.

In the franchise context, courts have routinely found that post-termination (of the Franchise Agreement) restrictive covenants are necessary to protect a franchise system by imposing minimal restrictions designed to prevent former franchisees from taking unfair advantage of the training and benefits they obtained from the franchisor. *Gafnea v. Pasquale Food Co.*, 454 So. 2d 1366 (Ala. 1984); *Carvel Corp. v. DePaola*, 2001 WL 528203 (Conn. Super. Ct. Apr. 24, 2011) (franchisor has a legitimate interest in protecting its know-how, trade secrets, goodwill, and the integrity of its franchise system; the franchisee's continued use of the franchisor's proprietary information in a competing operation, without paying the franchise fees and other fees provided for by the agreements, "tends to undermine the integrity of the franchise system"); *DAR & Assocs., Inc. v. Uniforce Servs., Inc.*, 37 F. Supp. 2d 192 (E.D.N.Y. 1999) (franchisor's legitimate interest in enforcing noncompete provisions includes protecting its goodwill, know-how, confidential information, trade secrets, the integrity of the franchise system, customer and referral relationships, and the franchisor's desire to refranchise the market).

This does not mean that noncompete agreements of all forms are reasonable or enforceable. Nearly all jurisdictions place limitations on the enforceability of noncompete agreements, including the scope of services restrained, duration, and geographic area. Some examples of where courts have drawn these lines as to the reasonableness of non-compete covenants in the franchise context follow.

Scope of Activities Restrained

Courts will typically enforce noncompete covenants where the scope of the activity restrained is directly competitive with the franchisor's activities and no broader than necessary to

protect the franchisor's interests. *See Elder Care Providers of Indiana, Inc. v. Home Instead, Inc.*, 2017 WL 1106093 (S.D. Ind. Mar. 24, 2017) (declining to enforce noncompete covenant in franchise agreement because former franchisee's post-termination business was not directly competitive with the franchisor); *In re Saban*, 30 B.R. 534, 539-41 (B.A.P. 9th Cir. 1983) (finding post-termination noncompete reasonably necessary to protect franchisor's business interests); *Hobbs v. Pool*, 1987 WL 8004 (Ark. Ct. App. Mar. 18, 1987) (declining to enforce noncompete covenant against former franchisee because it potentially covered activities that were outside the scope contemplated by the parties to the agreement); *Liautaud v. Liautaud*, 221 F.3d 981, 986-87 (7th Cir. 2000) (noncompete provision that restricted franchisee from engaging in any sub sandwich business outside of Madison, Wisconsin was unenforceable under Illinois law because it imposed restrictions greater than necessary to protect the franchisor's legitimate business interests and was oppressive and was harmful to the public interest).

Time Limitations

Courts typically enforce covenants ranging from one to three years. *Snelling & Snelling, Inc. v. Dupay Enters., Inc.*, 609 P.2d 1062, 1065 (Ariz. Ct. App. 1980) (upholding three year covenant); *U.S. Security Assocs., Inc. v. Schwartz*, 2019 WL 10303652, at *5 (N.D. Ga. Feb. 15, 2019) (recognizing rebuttable statutory presumption under Georgia law that covenants of three years or less are reasonable in time); *7's Enters., Inc. v. Del Rosario*, 143 P.3d 23, 27 (Hawaii 2006) (three-year noncompete covenant in franchise agreement was reasonable to protect franchisor's interest); *Am. Express Fin. Advisors, Inc. v. Yantis*, 358 F. Supp. 2d 818, 828 (N. D. Iowa 2005) (finding agreement prohibiting franchisee from conducting business in the same geographic area for one year following termination of franchise agreement was reasonably necessary to protect the franchisor's legitimate business interests, including client lists and trade

secrets); *Total Car Franchising Corp. v. L&S Paint Works, Inc.,* 981 F. Supp. 1079 (M.D. Tenn. 1997) (two-year covenant reasonable); *Armstrong v. Taco Time International, Inc.,* 635 P.2d 1114, 1118–19 (Wash. App. 1981) (Washington Court of Appeals affirmed the trial court's reduction of a franchise agreement's five-year post-termination noncompete to two and a half years).

Geographic Scope of Noncompete

Courts that are asked to enforce a noncompete clause in a franchise agreement will enforce clauses that are limited to a geographic scope that is necessary to protect the franchisor's legitimate business interests. *See Snelling & Snelling, Inc. v. Dupay Enters., Inc.*, 609 P.2d 1062, 1065 (Ariz. Ct. App. 1980) (scope of 35 miles from franchised business was reasonable); *South Bend Consumers Club, Inc. v. United Consumers Club, Inc.*, 572 F. Supp. 209 (N.D. Ind. 1983) (granting franchisee's motion for summary judgment on the grounds that the franchise covenant was overbroad in geographic scope); *H&R Block, Inc. v. Lovelace*, 493 P.2d 205, 210 (Kan. 1972) (holding noncompete clause unenforceable because it had no geographic limitation; stating that noncompete clauses are only valid if reasonable and do not harm the public welfare). *Adcom Express, Inc. v. EPK, Inc.*, 1996 WL 266412, at *4 (Minn. Ct. App. May 21, 1996) (recognizing that a franchisor has "a legitimate interest in protecting itself or one of its franchisees from the individual competition of another franchisee already operating in a different market" and a 50-mile radius was reasonable in scope); *Jackson Hewitt, Inc. v. Greene,* 865 F. Supp. 1199 (E.D. Va. 1994) (upholding a one-year restriction in a 10-mile radius of the franchisee's former territory).

In short, there are a number of considerations that courts consider (often based on legislation) when determining whether to enforce a noncompetition agreement in the franchise context. The courts and legislatures are mindful of the various stakeholders when making these decisions—including the franchisor, franchisee, other franchisees in the system, and the public.

And courts carefully balance these concerns when determining whether, and to what extent, noncompetition agreements are enforceable in the franchise context.

Economic Impact of Franchising

A 2021 Report conducted by Oxford Economics found that franchise firms pay higher wages than their non-franchise counterparts, franchising expands opportunities for women and people of color, nearly two-thirds of franchise owners would not own a business without franchising, and the United States would lose 60,000 businesses and 1.8 million jobs without franchising. *See* Oxford Economics, *The Value of Franchising: A Report for the International Franchise Association* (September 2021).[3] The industry is responsible for nearly $800 billion in economic output and 8.2 million direct jobs. *Id.* Extending proposed rule 16 C.F.R. § 910 to the franchisor-franchisee relationship would harm franchisors, business owners, employees, and consumers alike and turn this critical industry on its head by declaring unlawful a critical tool to protect the franchise business model.

To the extent that that there should be any restrictions on the enforceability of noncompete agreements, particularly those in franchise agreements, these restrictions should be determined on a case-by-case basis as virtually every jurisdiction in the United States has done through statutory provisions and the courts, rather than through a singularly applicable rule promulgated on the federal level.

The NPRM Mischaracterizes the Franchise Industry and Relationship

Finally, while clearly dictum and not essential to the proposed rule, we note that the NPRM contains a number of characterizations of franchising that are pejorative, unsubstantiated, and, in

[3] Available at https://openforopportunity.com/wp-content/uploads/2021/09/IFA_The-Value-of-Franchising_Sep2021.pdf

our experience, false. (*See* 88 Fed. Reg. at 3520). We have addressed above the unsubstantiated claim that "by restricting a franchisee's ability to start a new business, franchisor/franchisee non-compete clauses could potentially stifle new business formation and innovation, reduce the earnings of franchisees, and have other negative effects." *Id.* In general, former franchisees who violate their post-termination covenants are almost always substituting one business for another, and their purported "innovation" primarily consists of appropriating what they have learned from their franchisor and fellow franchisees. It is for this reason that these copycat businesses are so frequently enjoined by the courts.

Likewise, the claim that "many franchisees lack bargaining power in the context of their relationship with franchisors and may be susceptible to coercion through the use of non-compete clauses" (*id.*) is both unsubstantiated and inaccurate in the overwhelming majority of franchise relationships. Buying a business opportunity through a franchise is not a compelled purchase, as some consumer purchases may be. Franchisees have the ultimate bargaining power: walk away and do not buy the franchise. The Commission should not regulate based upon unjustified tropes regarding franchising that are rarely accurate in today's economy.

Conclusion

For the reasons stated above, to the extent that the Commission promulgates any rule that affects the enforceability of noncompete provisions, it should explicitly exclude application to such covenants in franchise agreements.

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Respectfully submitted,

LATHROP GPM FRANCHISE GROUP

By: /s/ Michael L. Sturm
Lathrop GPM LLP
600 New Hampshire Avenue, N.W.
The Watergate – Suite 700
Washington, D.C. 20037
202.295.2200

/s/ Michael R. Gray
/s/ Jason T. Johnson
Lathrop GPM LLP
500 IDS Center
80 South Eighth Street
Minneapolis, MN 55402
612.632.3000

50711222v3