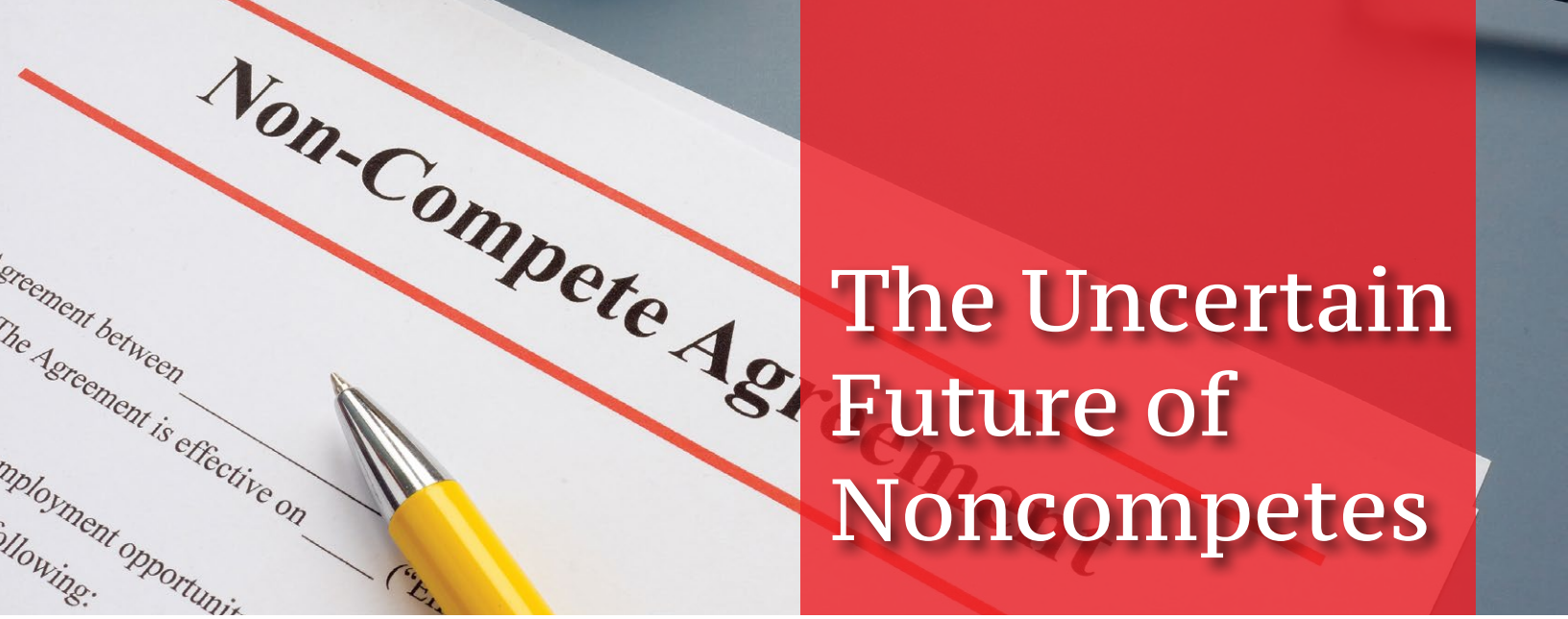

The Uncertain Future of Noncompetes

by Justin Klein

by Mark Fishbein

Covenants not to compete are a common feature of many employment agreements and typically restrict employees from working for competitors or starting similar businesses within a prescribed time frame and geography. Absent any uniform federal standard, various states tolerate and enforce these provisions differently. In California, North Dakota and Oklahoma, for example, noncompete agreements are generally prohibited in most contexts.

On Jan. 5, the Federal Trade Commission proposed a new rule that would implement a nationwide ban on the use of noncompete clauses and preempt and supersede any state statutes and regulations. The proposal would prevent all employers from entering into noncompete clauses with workers and also require employers to rescind existing noncompete clauses. According to FTC estimates, this would supposedly increase American employee earnings by roughly $250 billion-$300 billion per year.

Interestingly, FTC Commissioner Christine Wilson was the sole vote against the proposed rule, describing it as a radical departure from a century of legal precedent likely to cause unpredictable and unintended consequences. Several pro-business groups have already expressed their intent to mount challenges and have questioned whether the FTC has the authority to take this action.

On the other hand, proponents of the rule contend that noncompetes hurt business innovation by inhibiting ideas and the creation of startups and locking lower-wage workers into lower-paying jobs. In other words, the proposed rule is intended to create more freedom for workers to move between jobs and meaningfully contribute skill sets across multiple businesses in any particular industry.

Noncompete provisions are prevalent in the world of franchising and are part of virtually every franchise agreement in some form or fashion. And this is not a new trend – noncompetes in franchise agreements have existed for decades. In this context, these restrictive covenants extend beyond simply restricting an individual employee's right to compete, but the right of entire franchisee businesses, principals, guarantors and even spouses from competing vis-à-vis franchisors or within a franchise system.

This is true with the Planet Fitness® franchisee agreement, which includes such a provision restricting competition both in term and post-term of the franchise agreement. Interestingly, the proposed rule does not explicitly directly reference franchisees or the franchisor-franchisee relationship, but only a "worker," defined as:

"a natural person who works, whether paid or unpaid, for an employer. The term includes, without limitation, an employee, an individual classified as an independent contractor, extern, intern, volunteer, apprentice, or sole proprietor who provides a service to a client or customer. The term worker does not include a franchisee in the context of a franchisee-franchisor relationship; however, the term worker includes a natural person who works for the franchisee or franchisor. Noncompete clauses between franchisors and franchisees would remain subject to Federal antitrust law as well as all other applicable law."

This definition has been interpreted by some to, intentionally or not, implicate the franchisee-franchisor relationship considering the independent contractor status inherent in the relationship. Nonetheless, there are still uncertain and potentially far-ranging implications for franchising. Indeed, while the proposed rule may not ultimately apply to franchise agreements, it would apply to the relationship between franchisees and their employees. As such, franchisees may no longer be permitted to have such agreements with their own employees. Notably, many franchise agreements require some restrictions by franchisees as it relates to their employees, so it remains to be seen how this will be handled between franchisees and franchisors. The concern for franchisors would be that, as a practical matter, severe limits would be placed on restricting competition from individuals associated with the franchisee, if not necessarily the franchisee themself.

Another exception to the proposed rule is that it would not apply to a noncompete clause that is entered into by an owner, "substantial owner," "substantial member" or "substantial partner" who is selling a business entity, disposing of all the person's ownership interest in the entity, or who is selling all or substantially all the entity's operating assets. These situational noncompete clauses would remain subject to federal antitrust and other applicable laws.

Other notable features or implications of the proposed rule include:

• A definition of "noncompete clause," which means a contractual term between an employer and a worker that prevents the worker from seeking or accepting employment with a person

or operating a business after the conclusion of employment of the worker by the employer (as defined by federal law).

• A functional test to determine if a contractual provision is a noncompete clause – which would include a de facto noncompete clause that merely has the effect of post-employment prohibition. Examples of de facto clauses are broadly written nondisclosure agreements effectively precluding a worker from working in the same field and/or terms that require workers to pay for their own training costs. The FTC has stated that even other types of employment restrictions may fall under the proposed rule "if they are so broad in scope that they function as noncompetes."

• In conjunction with the requirement that employers rescind noncompete clauses, notice must be provided to both current and former employees by "individualized communication" that their noncompetes are no longer in effect and do so within 45 days of rescinding the clause.

The franchisor's interest in protecting their trade secrets and proprietary and confidential information and materials remains critical. Nothing here would prohibit alternative means or agreements for protection such as nondisclosure agreements and existing trade secrets laws. However, the proposed rule does eliminate an option that many franchisors will argue enhances the protection of the brand. It is also foreseeable that trade secret claims and related litigation may rise, and consequently, increase business costs. Franchisors and franchisees alike will need the assistance of counsel to navigate the potential implications.

In the case of individuals involved as franchisees, they will need to ascertain what future activities may remain restricted and which activities will not, in addition to evaluating their current noncompetes with their own employees.

The proposed rule will undoubtedly continue to meet resistance (and endorsement) from several quarters both inside and beyond the world of franchising. It does not take immediate effect but would become effective 60 days after being published in the Federal Register, and then compliance would be required after another 180 days.

The currently proposed definition of a "worker" and the rule's applicability has led to many questions and uncertainties as to the ultimate effect the proposed rule would have on current franchisor-franchisee relationships. Comments that are provided should offer additional clarity as to the direction the FTC takes with finalizing a rule.

It is possible the FTC may change course and explicitly bring the franchisor-franchisee relationship under the proposed rule. It would seem more likely, however, that the definition of "worker" remains as proposed, and thus does not prohibit franchisors from requiring franchisees to be bound by noncompete covenants. The scope of the proposed rule may also impact franchisors' and franchisees' ability to retain executives and management-level employees and to protect the brand and confidential information they possess.

It is critical for franchisors and franchisees alike to keep abreast of how this rulemaking process plays out. Diligent review is encouraged regarding all of your current and prospective agreements that may be impacted, including your employment agreements, franchise agreements and any agreements with independent contractors.

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